Annual Report

MISSION STATEMENT

Protecting Vermont's financial future, we strive to:

- **Be the best office of the treasury in the USA.**
- **Offer the best customer service possible.**
- **Do our part to make this office a great place to work.**
- **Give Vermont taxpayers an excellent value.**

January 15, 2005
State of Vermont

Office of the State Treasurer

www.vermonttreasurer.gov

Jeb Spaulding

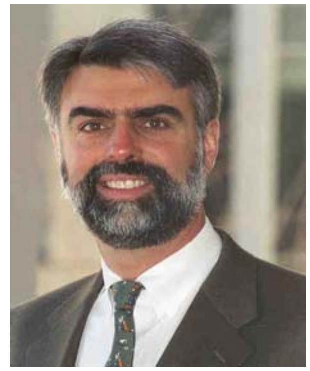
State Treasurer

THIS PAGE INTENTIONALLY LEFT BLANK

Table of Contents

Appendices

THIS PAGE INTENTIONALLY LEFT BLANK



TO: Members of the General Assembly
Honorable James H. Douglas, Governor
Citizens of Vermont

2004 was a busy and productive year at the Office of the State Treasurer. I am pleased to provide you with our annual report summarizing the services we provide, the accomplishments of our office over the past year, the financial results of our investment and capital financing efforts, as well as the various reporting requirements of our office.

The Office of the State Treasurer remains committed to maintaining Vermont's hard-earned reputation as a fiscally sound and disciplined state. We are pleased to report continued progress in improving our debt profile, as well as excellent investment performance. We are proud to report to you some of the recent initiatives we have taken to improve the efficiency of our operations, protect consumer interests, encourage corporate responsibility, and promote financial literacy. Much of our success in the past year is the result of mutual cooperation with the Legislature and the Administration; we look forward to continuing our partnership in the future.

As the custodian of the pension fund for the Vermont State Teachers' Retirement System, I do want to emphasize my concern about persistent underfunding by the State. I hope you will have a chance to study the relevant section of this report for information in this regard. Continued underfunding is not only shifting a funding obligation already incurred, at more expense, to future taxpayers, it may well undermine benefits and lead to increased contribution rates for teachers in the future.

Also, I would like to take this opportunity to urge the Governor and Legislature to create a sustainable spending plan for the coming years. The major rating agencies are fully aware of the imbalance between the current spending and revenue trajectory in the State's Medicaid program. They are watching carefully to see how Vermont addresses this and other cost pressures. In order to protect our fiscal reputation and credit rating we must develop balanced budgets, without gimmicks and without putting the State in an uncompetitive tax position. Before making new funding commitments, our first priority must be to ensure sustainable revenues for existing worthy programs.

Now, I would like to introduce our report by highlighting some of the accomplishments of our team over the past year:

Bank Reconciliation and Financial Operations

As noted by the Auditor in the FY03 audit, bank reconciliations are now completed by the Office of the Treasurer in a timely manner. We have since taken this function to a higher level, working to make further improvements and efficiencies. Staff training has been upgraded, not only to meet our own business requirements, but also to assist outside agencies and departments. Joint reviews of outstanding reconciling items with agencies/departments have resulted in the resolution of important procedural and system issues, thereby significantly reducing the amount of aged items on the reconciliations.

The reconciliation procedures implemented above, along with additional measures taken by the State Treasurer's Office, have effectively reduced the likelihood of fraud, thereby protecting the State's assets. Staff activities are now segregated so that one individual doesn't have the ability to both initiate and record check activity. Moving further from a paper-based payments system to electronic forms has also provided increased safety, while at the same time reducing operational costs. In fiscal year 2004, the Treasurer's Office processed approximately 1.62 million payments; 37.0% were electronic transfers, up 9.5% over the previous fiscal year. Direct deposit is a more efficient, less costly, and safer method by which to transfer funds. In December of 2004, 82% of retired municipal employees, 89% of retired State employees, and 92% of retired teachers received their monthly benefit payments via direct deposit. This is an increase from the December 2003 percentages of 77%, 88%, and 91% respectively. Currently 7,400 State employees, or 81% of the work force, have their biweekly pay deposited directly to their bank accounts. This is up from 7,165, or 78%, from the prior year.

Another significant enhancement has been the use of "positive pay" systems for all of our checking accounts. In a positive pay arrangement, a "check issued" file is sent to the bank at the time of each check run. These are then used to verify checks presented for payment. The bank matches check serial numbers and dollar amounts against the provided list of checks issued and the bank only pays those checks that match. An example of the effectiveness of this feature was evident in December 2004. The positive pay system prevented the posting of two fraudulent checks in the amount of $2,680.

Investing in Vermont

In August 2004, our office initiated the *Treasurer's Bank in Vermont Program* in order to support community banking, while earning a competitive return on State funds. The program is designed to be attractive to the wide range of banking institutions in Vermont, and is predicated on the belief that investing Vermont funds in Vermont, consistent with earning a competitive rate of return, is a good policy.

Historically, the State's short-term cash has been invested primarily out of state in government agency securities, high quality corporate commercial paper, and money market accounts at large financial institutions.

Now, approximately $30 million in State funds is available by bid, on an ongoing basis, for pre-qualified banks with branches in Vermont. As of December 31, 2004, 15 banks were pre-qualified to participate. Bids are accepted through the Internet on the first Wednesday of each month. The Treasurer's Office invests in bank CDs based on rank order of quoted bid rates and associated dollar levels until available funds for each scheduled bidding period are depleted. A block of funds is set aside for the scheduled bid in specified time frames. Some of the funds may be "short," generally thirty (30), sixty (60), ninety (90) and one hundred twenty (120)-day periods, while a portion is set aside for longer maturities, depending on the yield curve.

Since its inception in August, $41.6 million in Certificates of Deposit (CDs) has been awarded. As of December 31, 2004, $29 million is invested in certificates of deposit of varying maturities with rates well above comparable Treasury rates. This has been a win-win initiative for the Vermont Treasury and the banks. Considerable investment dollars stay in our home state and are available to promote community banking. At the same time, the State has earned extremely favorable rates.

For complete information about the *Treasurer's Bank in Vermont Program*, go to www.vermonttreasurer.gov.

This program is just one example of our ongoing commitment to seek out investment opportunities that support Vermont community and economic development while earning an appropriate return. Other examples include investments in 2004 by this office in the Vermont Community Loan Fund and the Vermont Development Credit Union. The three investment firms used by the Treasurer's Office to manage longer-term funds are all based in Vermont. They are National Life Capital Management, Hanson Investment Management, and Prentiss Smith & Company.

We have provided educational sessions and materials for the three pension boards about economically targeted investing, and are hopeful that appropriate in-state investment opportunities will be considered in the future.

As part of a major bond re-funding issue in 2004, approximately $57 million of bonds were sold to retail customers predominantly residing in Vermont. This was the largest offering of State of Vermont bonds available for Vermont investors in recent history.

Vermont Women and Money Conference

Well over 300 women attended the Vermont Women and Money Conference hosted by the State Treasurer's Office and the Vermont Commission on Women's Education and Research Foundation in September 2004. We received rave reviews about the practical advice and tools provided on money management, retirement planning, and investment strategies to women of all ages and economic backgrounds.

Pension Investments

The combined assets of the Vermont State Employees' Retirement System (VSERS), the Vermont State Teachers' Retirement System of Vermont (VSTRS), and the Vermont Municipal Employees' Retirement System (VMERS) were approximately $2.5 billion on June 30, 2004.

Fiscal Year 2004 investment returns were quite favorable: 15.7% for both VSTRS and VSERS and 14.8% for VMERS. That compares to FY 2003 returns of 5.6% for VSTRS, 4.6% for VSERS, and 1.9% VMERS. For the ten years ended June 30, 2004, the median annualized return for all public pension funds in the United States was 9.7%, compared to 10.6% for VSTRS, 9.9% for VSERS, and 10.8% for VMERS.

I am very pleased that board members from the three retirement boards agreed to work together to initiate a major revamping of their respective large cap domestic equity portfolios involving increased use of enhanced indexing strategies in order to produce superior rates of return with less risk and to effect a significant reduction in investment management fees. Though we are still in the final stages of negotiation with newly selected managers, estimated fee savings are in the range of hundreds of thousands of dollars per year.

At my request, the VSERS and VSTRS boards have agreed to consider allocating a small portion of funds to an environmentally sound investment strategy by directing our pension consultant, New England Pension Consultants (NEPC), to conduct a Request for Proposals (RFP) for an environmentally-managed large cap mandate. No decision will be made about whether to select and fund a manager until review of the proposals is complete. Manager investment performance expectations and benchmarks will be the same as for any other manager. The objective of this intitiative is to reduce environmental and associated financial risk to our portfolios, to enhance long-term investment returns, and to encourage environmentally responsible corporate management.

A significant restructuring of the State's deferred compensation plan was completed this past year, improving the investment options available to plan participants while minimizing fees.

Unclaimed Property Dormancy and Demutualization

In 2003, we worked closely with the Legislature to enact changes in the unclaimed property law to accelerate the time frame in which private holders of unclaimed property must transfer lost items, such as stocks, security deposits, pay checks, insurance policies, and bank CDs, into State custody. This enables our office to begin reunification efforts sooner, and increases the likelihood that Vermonters will actually be reunited with their lost property.

The statutory changes that took effect in fiscal year 2004 resulted in a record $19.2 million in unclaimed funds being remitted to the State, up from $3.3 million in 2003. Since a portion of this money reverts to the general fund based on retention schedules, $7.8 million was transferred to the General Fund last year, up from $1.7 million in 2003.

Now that these funds are centralized at the State Treasurer's Office, the fiscal year 2005 focus will be to re-unite these funds with their rightful owners. This report details our plans in this regard. Keep in mind that there is no time limit for citizens to claim their, or their ancestors', unclaimed property.

Retirement Operations Improvements

In an effort to improve productivity, cost-effectiveness and internal control safeguards, an expert management consultant was employed to assess the organizational and day-to-day operations and procedures in the Retirement Division and to make recommendations for improvement. As a result, a new client-focused service delivery model was adopted, positions were revised and converted, and new technologies were put in place I am very pleased to report that I regularly receive compliments from customers about their interaction with our staff.

With approximately 41,400 active, inactive, terminated vested, and retired members of the three state–level retirement systems, this is a very busy office. Among other duties, staff conducted over 1,000 counseling sessions, conducted 64 informational sessions across Vermont, calculated nearly 5,000 retirement estimates, and processed close to 700 retirements.

Capital Financing and Debt

Vermont's debt profile continued to improve in Fiscal Year 2004.

While the national trend has been to increase debt authorizations, the State of Vermont has reduced its total level of outstanding long-term debt over several years. The State's net tax-supported debt has fallen from $503.9 million in Fiscal Year 2000 to $444.7 million for Fiscal Year 2004.

The annual State Debt Medians Report from Moody's Investors Service shows Vermont with the largest ranking improvement in the country for tax-supported debt per capita and tax-supported debt as a percent of personal income, two key indicators considered by rating agencies in determining a state's credit rating. Vermont improved from the 16th highest state in debt per capita in FY'03 to 24th in FY'04. In debt as a percentage of personal income, Vermont improved from the 17th highest to the 25th.

Vermont enjoys the best composite bond rating of any New England State — AA+ or Aa1 by all three of the major rating agencies. My long-term goal is for Vermont to join nine other states in the country with AAA ratings. This year's progress in the Moody's rankings indicates to me that such a goal is attainable, assuming a continued commitment to careful financial and debt management, and broadening Vermont's economy.

One advantage Vermont receives from its favorable credit rating is lower interest rates when it borrows new money or refinances outstanding debt.

In order to capture savings from low interest rates, the State re-funded $136.9 million of outstanding general obligation debt, comprising over 30 percent of our total outstanding debt. That will produce gross savings of approximately $7 million and annual debt service savings of about $500,000 over the next 14 years. As part of the refunding process, approximately $57 million of bonds were sold to retail customers predominantly residing in Vermont. This was the largest offering of State of Vermont bonds available for Vermont investors in recent history.

The Capital Debt Affordability Advisory Committee (CDAAC) has recommended raising the state's annual bonding level nearly 10% next year to $45 million. That would be up from $41 million this year and $39 million last year. The Committee recognizes that Vermont has a great deal of demand for capital projects and believes that a $45 million level of new bonding will be effectively balancing the need to invest in state infrastructure with protecting our improved State debt ratios. Borrowing at a $45 million level next year will allow Vermont to maintain its debt as a percent of personal income ratio (a key indicator for credit rating agencies) below the national median, something the state has worked hard to accomplish through several years of level or reduced bonding authorizations.

Investor and Corporate Responsibility

As fiduciaries for the State's pension funds and the common trust fund, the trustees of the Vermont retirement systems and the State Treasurer are required to act prudently and in the long-term economic interest of fund beneficiaries. The stocks purchased by investment managers for Vermont funds are assets that carry a voting responsibility which must be exercised with the same prudence. Shareholders are obligated to vote each year on certain significant issues that may affect the future financial performance of the company. Until last year, proxy-voting responsibilities were delegated from the retirement systems and the Treasurer's Office to external investment managers with very little guidance. Research compiled by the Treasurer's Office has indicated that votes were often inconsistent and contradictory from one manager to the next, and often contradictory to Vermont policies and values.

After considerable debate and deliberation, the three retirement boards and this office adopted a common proxy voting policy statement and guidelines last spring. The Policy's corporate governance guidelines include voting policies relating to boards of directors, auditors, shareholder rights, and executive and director compensation. The Policy's corporate responsibility and accountability guidelines include voting policies on environmental issues such as climate change and environmental reporting, as well as workplace issues such as equal employment opportunities, human rights, and labor codes. A copy of this policy may be obtained on the Vermont Treasurer's Web site.

As expected in the first year of policy implementation, the first audit of proxy votes cast in the first half of calendar 2004 revealed varying levels of policy compliance, including several firms with incorrect votes of less than 10 percent and other firms with incorrect votes in excess of 50 percent. With the audit information, the Treasurer's office has the ability to work with firms that are not voting in a manner consistent with the Policy to improve their voting in the future. This also provides a forum to educate investment managers on issues that concern Vermonters.

In response to decisions by several large U.S. pharmaceutical companies to limit supplies to Canadian pharmacies that allow reimportation of their prescription drugs to U.S. residents, Vermont's two largest pension funds have joined several of their counterparts in an effort to reverse those policies. At my request, the VSERS and VSTRS Boards have agreed to cosponsor shareholder proposals to be considered at the 2005 corporate annual meetings of Pfizer, Eli Lilly, and Wyeth Pharmaceuticals that request the companies to reverse policies that constrain the reimportation of prescription drugs into the U.S. by limiting the supply of drugs.

Naturally, we want these companies to make money for us, and I realize that they have many admirable attributes, but I do not believe the effort to block reimportation of products from Canada and other countries is necessary to protect either the interests of investors or the safety of consumers. Therefore, I consider the development and filing of a resolution that allows the shareholder owners to request reversal of this policy to be prudent and consistent with my fiduciary responsibilities. By actively limiting sales and creating artificial shortages of products, the companies may well be forsaking long-term market development and reputation for higher profits in the near term. In addition, their actions are likely to cause regulatory or legal intervention that will have a greater impact on profitability than if the companies responded to this issue in a public-spirited fashion.

I have worked with the National Association of State Treasurers to support a number of corporate governance reforms, including the reporting of stock options as an expense in the same year that they are granted, the elimination of government financial incentives allowing American corporations to re-incorporate overseas, and creating a practical process for shareholders to be able to nominate members to boards of directors. I joined eight other state and city chief investment officers and pension fund officials in an effort calling on the U.S. Securities and Exchange Commission (SEC) to approve a rule allowing shareholders to directly nominate and elect candidates for corporate boards of directors. I was also part of a group of state and city investment officers that called on the SEC to require publicly traded companies to disclose to shareholders their political contributions.

I am a founding member of the Investor Network on Climate Risk and joined with eight other state and city treasurers and comptrollers at the United Nations to issue a 10-point "Call for Action" to the US financial community for increased disclosure and analysis of the risks posed by climate change to institutional and individual investors. I believe that over the long term, climate change and global warming pose significant dangers to investors and whole economies. As a trustee of Vermont's pension funds, which are long-term investments, and as a state official concerned with protecting Vermont's financial future, I am compelled to do my part to encourage companies to analyze and disclose potential risks and liabilities in this area. As part of this effort, I supported a petition to the SEC for enforcement of environmental risk disclosure requirements. I was a panelist at a climate change forum at the JFK School of Government in the fall and have proposed investment strategies that incorporate environmental concerns in the investment process.

Post-Employment Benefits

Recently adopted rules by the Governmental Accounting Standards Board (GASB 43 &45) covering non-pension post-employment benefits, primarily health insurance, will have major financial and disclosure ramifications for the State of Vermont beginning in Fiscal Year 2008. For the first time, public sector entities will be expected to report the future costs of these benefits on their balance sheets. The Standards do not require pre-funding such benefits, but the basis applied by the Standards for measurement of costs and liabilities for these benefits is far more conservative, and therefore results in larger yearly cost and liability accruals, if they are funded on a pay-as-you-go basis — as they presently are in Vermont and many other states — and not pre-funded in the same manner as traditional pension benefits.

A recently completed analysis by Mellon for the Vermont State Teachers' Retirement System indicated that an annual contribution of approximately $41 million would be necessary in Fiscal Year 2005 to provide pre-funding for the future liability of VSTRS' retiree medical plans at a level that could be deemed adequate under terms of the new GASB standards. Since we are currently paying roughly $10 million in health insurance premiums for this coverage, the net increase in annual costs associated with pre-funding would be about $31 million. However, if we were to elect not to move toward full funding, the basis for the calculation of the new accounting expense that must be charged for VSTRS post-retirement medical benefits under the new standards would be far more conservative than it would be if a policy of pre-funding were adopted — involving, for example, the amortization of an unfunded liability for medical benefits of $1.5 billion instead of one of less than $.5 billion — and the accrual of additional liabilities for these benefits required in the absence of pre-funding would be expected to add more than $1 billion in obligations to the State's balance sheet within a few short years of the effective date of the new Standards.

A similar analysis has been prepared for the Vermont State Employees' Retirement System and the net increase to provide pre-funding for the future liability of VSERS' retiree medical plans at a level that could be deemed adequate under terms of the new GASB standards in Fiscal Year 2005 would be close to $25 million.

The actuary's report included recommendations on what our next steps might be, including the establishment of a dedicated trust fund and beginning pre-funding now. The Administration, Legislature, Retirement Boards, and the Treasurer must carefully review and plan for this issue over the next several months.

Connecting to the Future

This has been an exciting year for technology advances in our office.

In the spring we deployed a new and highly improved Web site. You will find expanded and updated information on all aspects of our office at www.vermonttreasurer.gov. There is also a new interactive feature called *Tomorrow's Money* that provides useful money management advice for a wide range of Vermonters.

We adopted a more sophisticated telephone system and successfully implemented a new Web-based system for reporting salaries and contributions for all active teachers across Vermont. This will provide greater efficiencies for the 308 reporting entities.

The long-anticipated retirement information technology reengineering project was launched last year with the recruitment of a project manager and expert consulting services. This is a desperately needed initiative to replace the Retirement Division's antiquated 25-year-old computer system, which is causing reliability problems and requiring that too many functions be done manually. In FY 2005, file imaging will take place and a new main system will be selected after careful RFP review in cooperation with the Department of Information and Innovation.

Acknowledgements

I would like to sincerely thank all of the dedicated and hardworking members of the Treasury team for their support and commitment to serving Vermonters. I have enjoyed working with the Legislature and the Administration to protect Vermont's financial future and I look forward to working with both these entities in the coming year. My staff and I are available to review the information in this report, and welcome your inquiries and/or comments.

Sincerely,

Jeb Spaulding
State Treasurer

About the Vermont State Treasurer's Office

Responsibilities

The State Treasurer's Office is responsible for a wide range of administrative and service duties as prescribed by State statutes:

- Investment of State funds.
- Issuing of all state bonds authorized by the General Assembly.
- Serving as the central bank for State agencies.
- Management of the State's cash balances, processing of checks, and the reconciliation of payroll and vendor checks.
- Safeguarding and return of unclaimed or abandoned property, which is property being held in trust by the State until the rightful owner can be located.
- Administration of three major pension plans, the deferred compensation plan, and the defined contribution plan for State employees, teachers, and participating municipalities.

Our Commitment to Vermonters

The State Treasury manages money that belongs to all of the citizens of Vermont. The Treasurer and staff are committed to doing this honestly, efficiently, responsibly, and professionally. The Treasury operates as a business, serving the needs of Vermonters while working to save the taxpayers money and earn the highest possible return in its funds within acceptable risk parameters.

Protecting Vermont's financial future, we strive to be the best office of the treasury in the USA; offer the best customer service possible; do our part to make the Treasurer's office a great place to work; and give Vermont taxpayers an excellent value.

Administration and Organization

The Treasury is organized into an executive office and five divisions. The executive office is responsible for overall strategic planning, legislative initiatives, constituent relations, debt management, and supervision of the divisions.

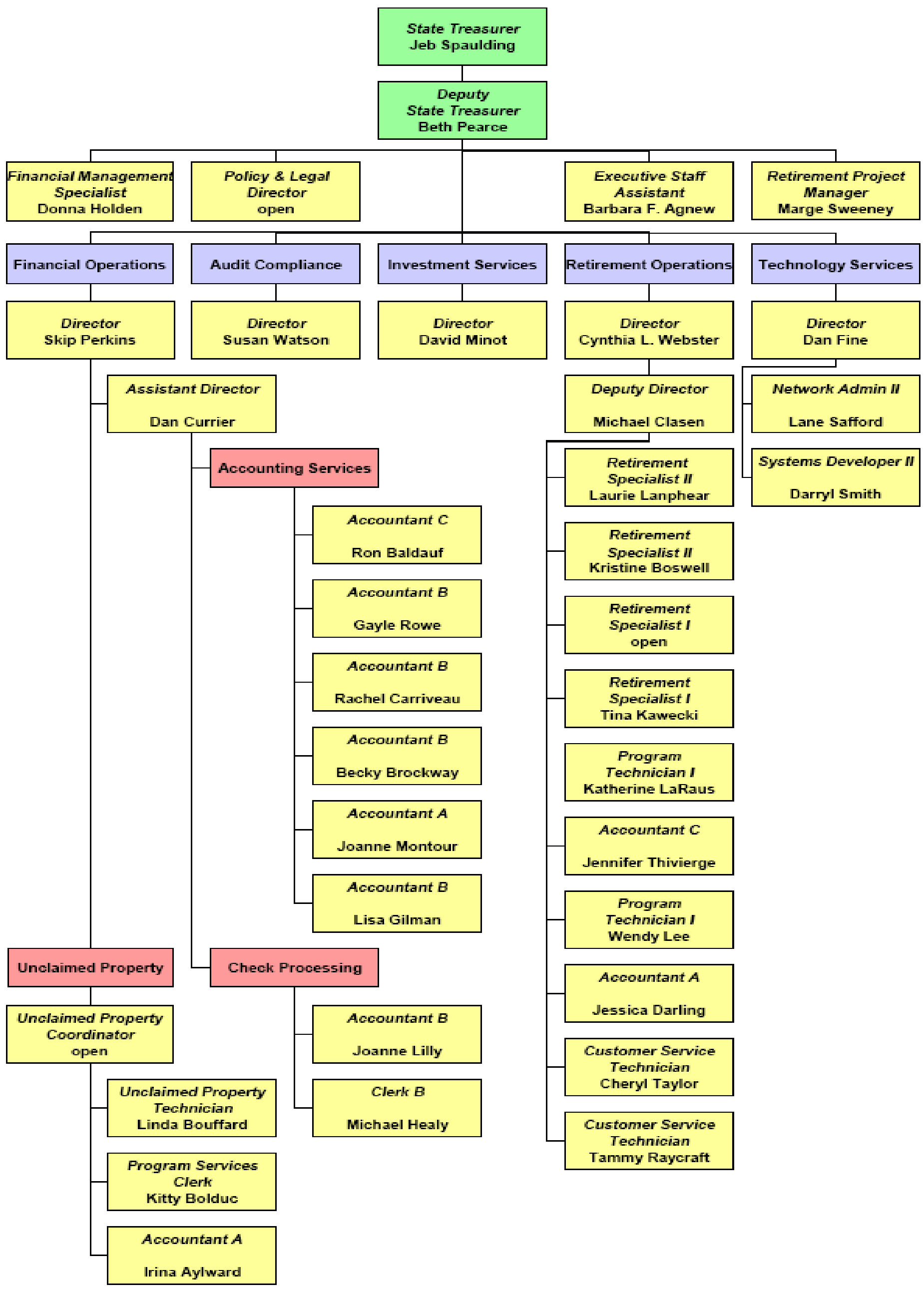
- Financial Operations is responsible for the State's banking, cash management, and financial transaction services. This division also contains the Unclaimed Property section of the office, serving as caretakers of abandoned or unclaimed property while seeking to return it to its proper owners.
- Finance and Investment Services provides cash, investments, and debt management for the State of Vermont and the three pension systems (State Employees, Teachers, and Municipal Employees) that are administered by the Treasurer's Office.
- Technology Services is responsible for developing and maintaining automated systems, providing appropriate access to information, maintaining the Treasurer's Office Web sites, maintaining the office network and its security, and providing automated interaction with other departments and entities outside state government.
- The Retirement Division administers the three public retirement systems authorized by the Legislature. They are for state employees, school teachers (grades K-12), and municipal employees. Approximately

Administration and Organization, continued

41,400 people are covered by these retirement systems.

- The Audit Compliance Division was created in 1999 to conduct independent reviews of financial operations and controls within the State Treasurer's Office. The division determines whether acceptable policies and procedures are followed, established standards are met, and resources are used efficiently and economically.

Exhibit #1
Office of the State Treasurer



Vermont Retirement Systems

The State Treasurer's Office administers three statutory defined benefit pension plans with 24,027 active members, 6,490 inactive members, 1,589 terminated vested members, and 9,318 retired members as of June 30, 2004. These are the Vermont State Teachers' Retirement System (VSTRS), the Vermont State Employees' Retirement System (VSERS), and the Vermont Municipal Employees' Retirement System (VMERS). Both VSTRS and VSERS are funded by employee contributions as well as those made by the State. The Vermont Municipal Employees' Retirement does not have a state contribution.

In each case, a board of trustees is charged with the responsibility of general administration and proper operation of the retirement system. Pension investment functions and day-to day retirement operations are administered through the State Treasurer's Office based on policies and guidelines adopted by the boards of trustees. The State Treasurer is a member, *ex officio*, of each trustee board.

During the past year the boards have taken on ambitious agendas. All three boards have begun a process to reconfigure their investment strategy to incorporate index funds, where appropriate, to reduce investment manager costs and improve the overall rate of return. The VSERS and VSTRS boards have agreed to consider an investment manager search for an environmental fund. Such an investment manager would use positive screens to identify and invest in companies that employ environmentally sound policies that add to their bottom line, making these attractive opportunities.

In a period of corporate and investment scandals, the trustees have had to respond to an increasingly turbulent financial environment. The trustees have taken quick action as needed, and have taken significant positive steps relative to their fiduciary responsibility. As shareholders, the retirement systems have the opportunity to cast votes by proxy on resolutions brought before corporate boards of directors on issues ranging from corporate governance to social and environmental concerns. The Treasurer's Office and the boards developed a system to encourage Vermont's investment managers to vote consistent with sound corporate governance and responsible corporate practices.

The boards have approved an extensive set of proxy voting guidelines to be used by their investment managers when voting on a wide range of issues up for consideration at corporate annual meetings. Most of the proxy guidelines relate to questions of corporate governance, such as executive compensation, auditor independence, and shareholder rights, but they also include guidance on a range of subjects relating to environmental disclosure, toxic emissions, employment practices, and non-discrimination.

The Treasurer and the retirement system boards selected Institutional Shareholder Services, Inc., to help manage their proxy voting responsibilities in the future. The policies were adopted in February 2004.

This is the first year of implementation of the guidelines. As expected, there were varying levels of policy compliance, including several firms with incorrect

Vermont Retirement Systems, continued

votes of less than 10 percent, and other firms with incorrect votes in excess of 50 percent. With this audit information, the Treasurer's Office has the ability to work with firms that are not voting consistent with the policy to improve their voting patterns in the future.

The VSERS and VSTRS boards approved a proposal by the State Treasurer to co-sponsor shareholder proposals to be considered at the 2005 corporate annual meetings of Pfizer, Eli Lilly, and Wyeth Pharmaceuticals requesting the companies to adopt policies that do not constrain the re-importation of prescription drugs into the U.S. by limiting the supply of drugs.

The retirement systems are also responding to significant challenges in the area of retirement benefits and funding. The VSTRS has taken a pro-active stance on the issue of teacher funding, advocating for full funding of the teachers' system. A discussion of funding issues is included in a later section of the report.

In addition, the VSTRS and VSERS boards have begun to address the issues related to health care costs and post-employment health benefits. Recently, the Fitch Rating Service noted that, "The 'extraordinary growth' of health care and health insurance costs over the past five years will continue to take its toll on local governments in the future and is expected to become an increasingly important credit consideration." Vermont's teachers and state systems, which provide health care insurance, are no exception.

Further, the Governmental Accounting Standards Board (GASB) reporting rules include pending changes that are expected to increase existing health care cost pressures. GASB 43 and GASB 45 will require state and local governments to accrue "other post-employment benefits" (OPEB) in a manner consistent with the way they now account for defined benefit pension plans. These will be reported in the State's financials in FY2008.

A recently completed analysis by Mellon for the Vermont State Teachers' Retirement System indicated that an annual contribution of approximately $41 million would be necessary in Fiscal Year 2005 to provide pre-funding for the future liability of VSTRS' retiree medical plans at a level that could be deemed adequate under terms of the new GASB standards. Since we are currently paying roughly $10 million in health insurance premiums for this coverage, the net increase in annual costs associated with pre-funding would be about $31 million. However, if we were to elect not to move toward full funding, the basis for the calculation of the new accounting expense that must be charged for VSTRS post-retirement medical benefits under the new standards would be far more conservative than it would be if a policy of pre-funding were adopted.

Such a basis could include, for example, the amortization of an unfunded liability for medical benefits of $1.5 billion instead of one of less than $.5 billion, and the accrual of additional liabilities for these benefits required in the absence of pre-funding would be expected to add more than $1 billion in obligations to the State's balance sheet within a few short years of the effective date of the new Standards.

Vermont Retirement Systems, continued

A similar analysis has been prepared for the Vermont State Employees' Retirement System, and the net increase to provide pre-funding for the future liability of VSTRS' retiree medical plans at a level that could be deemed adequate under terms of the new GASB standards in Fiscal Year 2005 would be close to $25 million.

The Administration, Legislature, Retirement Boards, and the Treasurer must carefully review and plan for this issue over the next several months.

Vermont State Teachers' Retirement System Board (VSTRS)

The board is comprised, by statute, of the Commissioner of Education, *ex officio*; the Commissioner of Banking, Insurance, Securities and Health Care Administration (BISHCA), *ex officio*; the State Treasurer, *ex officio*; two members of the system elected by members of the system; and one member elected by the board of directors of the Association of Retired Teachers of Vermont.

Board of Trustees and Staff
Seated: Joe Mackey, Chair (on left), and Jay Kaplan. Back row left to right: Vaughn Altemus; Jon Harris, Vice-Chair; State Treasurer Jeb Spaulding; Thomas Candon; and Retirement Operations Director Cynthia Webster.

Vermont State Employees' Retirement System Board (VSERS)

The board is comprised, by statute, of the Governor or his designated representative, *ex officio*; the State Treasurer, *ex officio*; the Commissioner of Personnel, *ex officio*; the Commissioner of Finance and Management, *ex* officio; three members of the Vermont State Employees' Association (VSEA) who are members of the system, each elected by the Association; and one retired state employee who is a beneficiary of the system, to be elected by the Vermont Retired State Employees' Association (VRSEA).

Members: Warren Whitney, Chair; Rob Hoffman, Richard Johannesen and Robert Hooper. Other members not shown: William Harkness, Jeb Spaulding, Vice-Chair, Janice Abair, Cindy LaWare, and alternates Catherine Simpson and Wayne Calderara.

Vermont Municipal Employees' Retirement System Board (VMERS)

The board is comprised, by statute, of a representative designated by the Governor; the State Treasurer; and two municipal employees and one municipal official elected by the membership of the system.

Left to right: Steve Jeffrey, Chair; Marie Duquette, W. John "Jack" Mitchell, Vice-Chair, David Lewis, and staff David Minot and Cynthia Webster.

Retirement Division Operations

ACCOMPLISHMENTS IN 2004

- Staff of the Retirement Division conducted 1,070 individual counseling sessions and processed a total of 679 retirements for members of the three systems during the 2004 calendar year. Staff also calculated over 4,700 retirement estimates at the request of prospective retirees. Staff conducted 64 informational sessions across Vermont for members of the three systems in 2004, and approximately 1,830 individuals were in attendance at these sessions.

- The Retirement Division in collaboration with the IT Division successfully implemented a new Web-based system for reporting salary and contributions for all active teachers across Vermont. This new system will provide greater efficiencies for the 308 reporting entities.

- Following a competitive bidding process, a management consultant was selected to assess the organizational and the day-to-day operations and procedures in the Retirement Division and make recommendations on its productivity, cost-effectiveness, and internal control safeguards. The Division implemented many of the recommendations included in the consultant's report during 2004, and plans to adopt additional initiatives in 2005.

- A Deputy Director of Retirement Operations was hired in May to supervise the staff and day-to-day operations of the Division. The Division also converted an existing position into a Retirement Specialist II position to assist with the increasing number of requests for estimates and counseling sessions, and a second accounting position was also created. Additionally, an automated phone service was installed to more efficiently direct all incoming phone calls to the Treasurer's Office.

- A new service delivery model was adopted that organizes the staff into three key areas or units. These units are: 1. Member Services – which includes the four Retirement Specialists and two supporting staff; 2) Employer Services – which includes two Program Technicians; and 3) Accounting Services – which includes two accountants.

- Finally, a major restructuring of the deferred compensation plan was completed, improving the investment options available to plan participants while minimizing fees.

Retirement Division Operations

Overview

The State Treasurer's Office administers three statutory defined benefit pension plans: the State Teachers' Retirement System of Vermont with 10,315 active, 3,084 inactive, 560 terminated vested, and 4,386 retired members as of June 30, 2004; the Vermont State Employees' Retirement System with 8,079 active, 968 inactive, 819 terminated vested, and 3,833 retired members; and the Vermont Municipal Employees' Retirement System, with 5,633 active, 2,438 inactive, 210 terminated vested, and 1,099 retired members.

In addition, the Office administers two defined contribution plans that are offered as an alternative to the defined benefit plans for certain employee groups; a deferred compensation (457) program for state employees; and a single depository investment account (SDIA), a tax-sheltered account funded through employee transfers from a non-contributing system. Although Retirement contracts with third-party administrators to handle the investment options and day-to-day bookkeeping responsibilities for these plans, the office is responsible for providing new hires with information and comparisons of projected benefits, and also conducts one-on-one counseling to assist in the election process. Staff members process all transfers between the plans, and receive and transmit all contributions on behalf of the defined contribution members.

The Retirement Division is currently comprised of 12 staff members. The primary function of the staff is to serve the needs of the active contributing members and retired members receiving benefits payments. On the active member side, the Retirement Division oversees enrollments, transfers, refunds, and adjustments to members' accounts. On the retiree side, the Division oversees the issuance of the payroll, changes to dependents, adjustments to payments, and replacement checks. Other responsibilities include employee re-instatements, calculation of buybacks and refunds, disability retirements, and determination of survivor benefits.

There is an extremely high volume of inquiries by phone, e-mail, and face-to-face appointments or walk-ins. The retirement counselors provide one-on-one counseling to prospective retirees. Counselors provide estimates of pension and beneficiary payments by verifying a member's creditable service, salaries, and personal information (i.e., date of birth, beneficiary date of birth, etc.). Counselors and supervisory staff also conduct informational seminars throughout the state.

Staff of the Retirement Division conducted 1,070 individual counseling sessions and processed a total of 679 retirements for members of the three systems during the 2004 calendar year — 321 Teacher retirees, 263 State retirees, and 95 retirees in the Municipal system. Staff also calculated over 4,700 retirement estimates at the request of prospective retirees. Several staff members conducted 64 informational sessions across Vermont for about 1,830 members of the three systems in 2004.

The workload of retirement staff has increased steadily over the years, as retirement plans have become more complex and the number of members has increased. Over the next five years, the volume of retirements to be processed and client contacts is expected to continue to grow.

In an effort to better deal with higher case loads, to meet clients' needs in a timely fashion, and to improve customer service, an RFP was issued in October 2003 to obtain the services of a management consultant. The consultant was retained last year to assess the current organizational and operational structure of the Retirement Operations Division, and to make recommendations for improving the productivity, cost-effectiveness, and internal control safeguards of the division.

The Division implemented many of the recommendations included in the consultant's report during 2004. A new client-focused, service delivery model was adopted that organizes the staff into three key areas or units: employer services, member services, and accounting.

Previously, many Retirement Division processes were based on the specific retirement system being served at the time, and staff and associated tasks were divided along these lines as well. However, many of the day-to-day services and benefits provided by the three retirement systems use common processing methods. The model recommended by the consultant creates a more manageable and efficient structure that will also enable staff to improve accountability and customer service.

This increased accountability will be supported over time by the use of meaningful and focused performance measures. The model requires a minimum of two staff persons within each unit to ensure adequate coverage and to allow for cross training that minimizes the risks when only one person knows how to complete specific tasks.

The Treasurer's Office also installed an automated telephone service to direct incoming calls to the appropriate division.

The Retirement Division is also preparing to replace its 25-year-old automated mainframe-based retirement system infrastructure with a modern and full-featured client server system. The change will facilitate faster turn-around for inquiries and requested services, easier access to needed information and documents, increased accuracy of information, and timely identification of problems.

In October 2004, the Division obtained the services of a consultant to conduct a formal needs assessment and prepare a plan for imaging records, selecting retirement administration software and providing related technology support. This project also includes activities in the areas of upgrade/modification review, the development of reporting and

Deputy Retirement Director Michael Clasen reviews a workshop agenda with Laurie Lanphear, retirement specialist.

information tools, and continued changes in the practices/interfaces with our business partners.

The first order of business is to implement a plan to provide imaging services to produce electronic images of the at least 1.5 million paper records that are currently stored in 80 filing cabinets in the Retirement Division office. All of these paper records are originals and are the only copy, which creates significant risk should the files be lost or accidentally destroyed. Producing electronic images with microfiche or microfilm back-ups will enable the Division to comply with current public record retention requirements, create efficiencies by enabling more than one staff to view the records at the same time, and reduce the amount of office space that is currently required to store the records.

Deferred Compensation Program

The Board of Trustees for the Vermont State Retirement System is responsible for a deferred compensation program that has been available since 1973 as a savings option for State employees, municipal employees, employees of agencies such as VSAC, VEDA, and VHFA, and members of the General Assembly. Because the deferred compensation plan qualifies as a Section 457 Plan under the Internal Revenue Code, the portion of salary that is deferred is not taxed at the time of deferral. On June 30, 2004, the plan had 5,176 State participants and 330 local participants for a total of 5,506 participants. Total assets in the plan were valued at $170.93 million. Participating employees made contributions in the amount of $13.7 million to the plan during FY'04.

In 2004, the Treasurer's Office and the VSERS Board undertook a comprehensive review of the deferred compensation plan to:

- Determine if the investment options offered by the plan are optimum choices given the considerations of diversification, risk and return.
- Assist in the development of investment policies for the plan.
- Recommend additions or deletions to investment options as needed.
- Provide a recommended transition plan and timeline incorporating any proposed changes in investment options.
- Conduct a review of the plan's pricing structure, including fund management fees and terms between each fund and its third party administrator (TPA).

As a result of that review, and with the assistance of New England Pension Consultants (NEPC), several changes were made to the plan. The 457 Plan added eight new investment options and, after careful review, the Vermont State Employees' Retirement System Board voted to discontinue six mutual funds and three profile portfolios. A mapping process was implemented to assure effective transition of participant assets from discontinued options to new options and to minimize disruption. The Board and the Treasurer's Office believe that this overhaul will provide an excellent range of options to participants, with a very attractive fee structure.

Defined Contribution Plan

A similar project was undertaken by the Treasurer's Office regarding the State's defined contribution plan; the process to implement those recommendations is under way. At July 31, 2004, this plan had 578 participants and net assets of $30,350,721.

Under the defined contribution plan, which is modeled after private sector 401(k) plans, employees contribute 2.85% of their annual salary to their individual accounts. The State makes a fixed contribution of 7% to each employee's account. Employees are responsible for making all investment decisions among options selected by the Treasurer. At retirement or termination, employees receive the amount of contributions in their accounts, plus investment earnings. The defined contribution plan provides portability for an increasingly mobile workforce. It also reduces the unfunded liability for the State because the State does not assume the liability of a future pension benefit.

Accounting staff Jennifer Thivierge and Jessica Darling review data accuracy.

The Vermont Municipal Employees' Retirement System was given statutory authority in 1999 to approve a defined contribution plan for its members. The Board implemented a defined contribution plan on July 1, 2000. The plan provides the employer municipality with the first option of deciding whether to offer a defined contribution plan to its employees. Once a municipality elects to offer the plan to all eligible employees or to specific employment groups, an individual employee has the choice to remain with the defined benefit plan or transfer to the new defined contribution plan. New employees of municipalities offering both a defined contribution plan and a defined benefit plan have a choice of either plan. As of July 31, 2004, 92 municipalities had offered the plan, with 484 participants and net assets of $7,603,229.

Pension Operations

The contributions made to the trust funds, in combination with investment return, largely fund the operations of the retirement plans including benefits, insurance (teachers and state system) and administrative expenses. The results of operations for the three systems are reported in detail in Appendix A of this report. Chart #1, however, is a synopsis of operations at a summary level. In Fiscal Year 2003, the investment environment improved and the combined results of the three defined benefit plans resulted in an increase in net assets of $81,571,561. In Fiscal Year 2004, investment returns continued to rebound, and an addition to net assets totaling $305,096,430 was realized.

Pension Funding Concern

As of June 30, 2004, the GASB 25 funded ratios for the three retirement systems were:

- Vermont Municipal Employees' Retirement System (VMERS), 103.5%
- Vermont State Employees' Retirement System (VSERS), 97.6%
- Vermont State Teachers' Retirement System (VSTRS), 90.2%

This percentage reflects the ratio between total assets of the system and total accrued liability, but not necessarily the health of the retirement systems. Although the GASB 25 ratios for the VSERS and VSTRS have improved (Chart #2) in recent years, relying on these ratios as an indicator of the financial health of these pension funds may lead to a false sense of security.

GASB 25 and the actuarial method used by our systems do not accurately reflect the effect of annual under-funding. Instead of the annual under-funding being added to the accrued liability measured by GASB 25, it simply gets added to the calculation of "normal costs" for the next year. That is one reason why, while the GASB 25 ratio improves and the portion of total required annual contribution for the accrued liability is fairly stable, the total required contribution (accrued liability and normal) is escalating rapidly. Other factors include demographics, actuarial experience, benefit enhancements, and market fluctuations.

When GASB 25 was created, it allowed for several alternative methods of developing actuarial valuations. The VSTRS and VSERS use the actuarial cost method known as "entry age normal cost with frozen initial liability." The statutes for both the VSTRS and VSERS specifically state:

> "The unfunded accrued liability determined by actuarial valuation as of June 30, 1988 shall be amortized over a period of years beginning July 1, 1988..."

This methodology can be particularly misleading in systems where the annual required contribution is not consistently funded, as is the case with the VSTRS system.

That actual contributions to VSTRS have been less than the actuarial recommendations will not be a surprise to many. However, charts #3 and #4 indicate a dramatic decrease in funding as a percentage of the actuarially recommended level in recent years. The level of underfunding has been worsening at a time when State revenues have been increasing, even beyond projections, and when the State has been generating moderate surpluses. In past economic and revenue downturns, the State has occasionally resorted to funding substantially less than the actuarial recommendation for a year or two, but when revenues rebounded, more adequate funding was forthcoming. That does not appear to be the case now. Hoping that somehow investment returns will compensate for this continued pattern of underfunding would be most imprudent.

The net pension obligation for VSTRS, which reflects the cumulative impact of underfunding, grew from $87.5 in FY'02 to $110.9 million in FY'04.

Such underfunding will inevitably increase the pension burden for future generations of taxpayers. Further, since the unpaid contributions will not have been invested as assumed, lost investment earnings will also need to be repaid. In fact, for each $1 million in shortfall, total additional contributions of $1.25 million will be required — basically, an additional 25¢ for every $1 shortfall — further adding to the future burden.

Actually, taxpayers in Vermont are already bearing the burden of past underfunding. An actuarial review of the VSTRS underfunding was conducted in 2003. The 2003 contribution rate of 9.53% would be about 6.22% if additional funding were not required to make up the shortfall. This translates to an additional contribution of over $14 million for the 2004 fiscal year on account of past shortfalls.

Continued underfunding not only increases the future cost to taxpayers for obligations already incurred; at the current scale, it may well undermine benefits and lead to increased contributions for future teachers.

Chart # 1

YEAR ENDED JUNE 30, 2004

Category	Vermont State Retirement Fund	State Teachers' Retirement Fund	Municipal Employees' Retirement Fund
SOURCES OF FUNDS			
Employee Contributions	$13,716,264	$21,088,345	$6,507,268
Employer Contributions	26,645,619	24,446,282	7,114,813
Other Income	695,397	267,330	2,125,294
Investment Income	138,426,552	166,325,045	27,271,821
APPLICATION OF FUNDS			
Retirement Benefits	44,637,116	55,246,342	5,694,080
Refunds	1,171,957	711,806	1,110,243
Health/Life Insurance Expenses	9,236,526	8,279,332	0
Administrative Expenses	659,447	805,495	151,228
Other Expenses	617,658	543,746	668,624
Addition to Net Assets Held in Trust for Pension Benefits	$123,161,128	$146,540,281	$35,395,021

Chart #2
Status of Pension Funding Progress (Based on GASB Statement No.25)

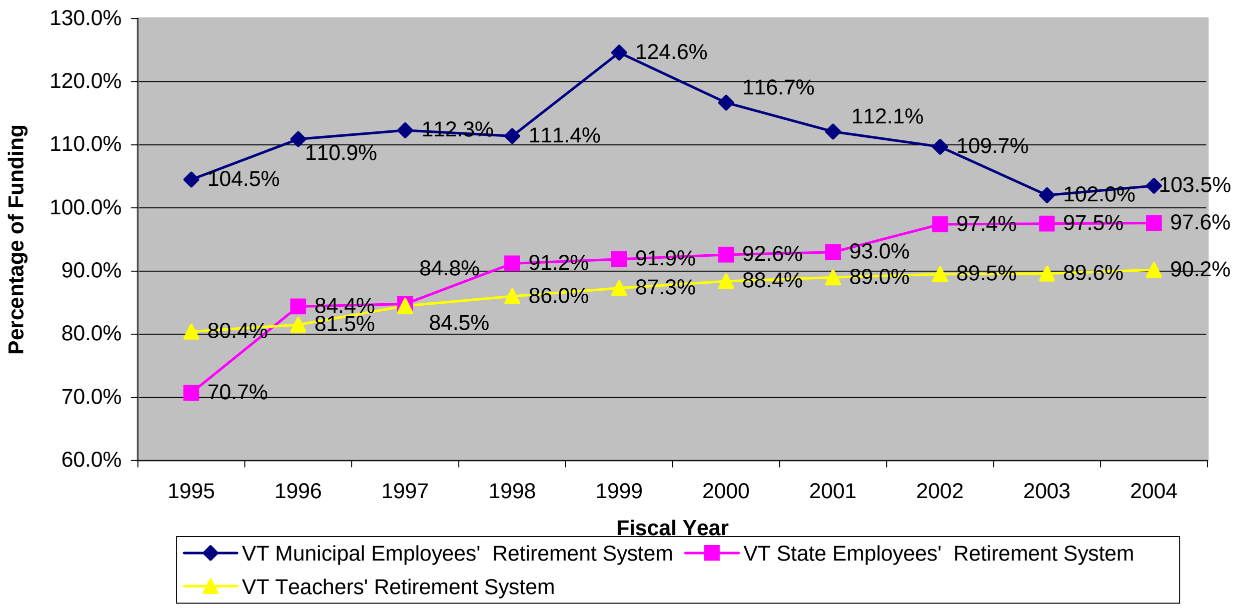
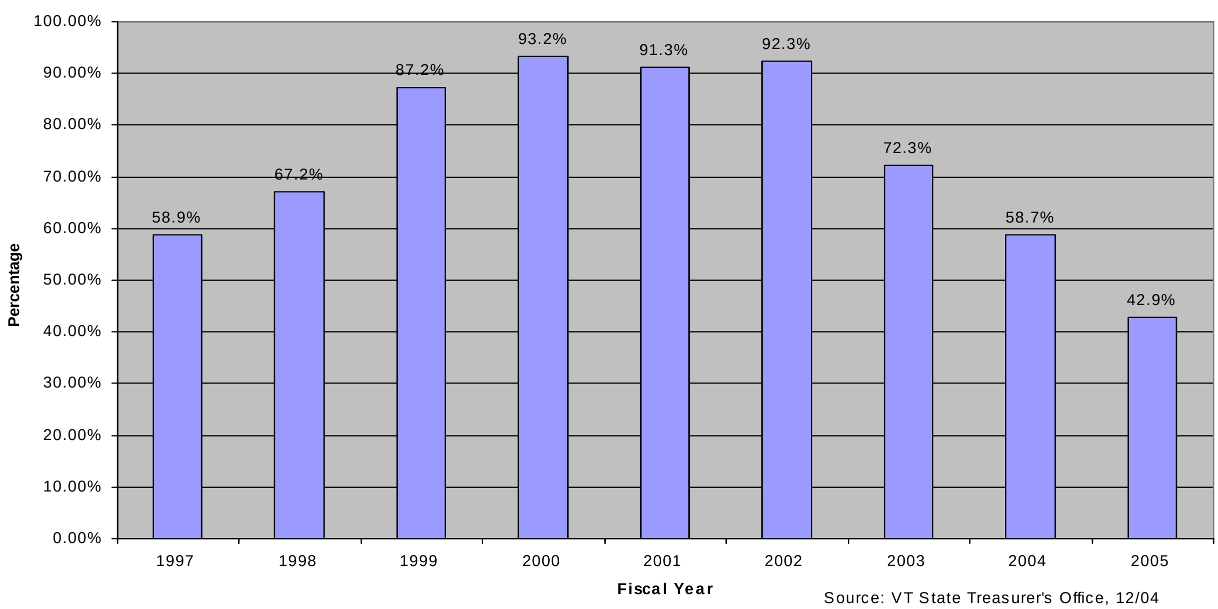


Chart #3
VSTRS Funding
Percentage of Actuarially Required Level Appropriated By Fiscal Year



Source: VT State Treasurer's Office, 12/04

Chart #4
Historical Funding Data for VSTRS and VSERS

TEACHERS RETIREMENT SYSTEM

Fiscal Year	Final Actuarial Request*	Actual Funding	Percent of Request	Market Value of Assets	Actuarial Value of Assets (AV)	AV % of Mkt Value	Pension Benefit Obligation	Actuarial Accrued Liability (AAL)	% Funded Market Value/PBO GASB 5 (MKT/PBO)	% Funded Actuarial value GASB 25 (AV/AAL)
2005	$47,714,318	$20,446,282	42.9%							
2004	$41,658,946	$24,446,282	58.7%	$1,245,650,105	$1,284,832,644	103.1%	$1,431,107,667	$1,424,662,000	87.0%	90.2%
2003	$28,279,810	$20,446,282	72.3%	$1,099,109,824	$1,218,000,794	110.8%	$1,306,864,372	$1,358,822,000	84.1%	89.6%
2002	$22,146,880	$20,446,282	92.3%	$1,065,978,943	$1,169,294,000	109.7%	$1,178,063,357	$1,307,202,000	90.5%	89.5%
2001	$20,970,278	$19,143,827	91.3%	$1,138,548,007	$1,116,846,000	98.1%	$1,087,419,007	$1,254,341,000	104.7%	89.0%
2000	$19,936,345	$18,586,240	93.2%	$1,190,498,179	$1,037,465,880	87.1%	$1,014,994,651	$1,174,087,000	117.3%	88.4%
1999	$20,723,874	$18,080,000	87.2%	$1,110,214,000	$931,056,000	83.9%	$935,311,000	$1,066,400,000	118.7%	87.3%
1998	$26,927,205	$18,106,000	67.2%	$1,006,493,000	$821,977,000	81.7%	$842,124,000	$955,694,000	119.5%	86.0%
1997	$30,721,768	$18,080,000	58.9%	$865,856,000	$717,396,000	82.9%	$802,481,000	$849,179,000	107.9%	84.5%
1996	$28,711,597	$11,480,000	40.0%	$703,392,000	$570,776,000	81.1%	$710,049,000	$700,377,000	99.1%	81.5%
1995	$27,451,926	$18,080,000	65.9%	$601,100,000	$520,850,000	86.6%	$630,889,000	$648,052,000	95.3%	80.4%
1994	$25,805,408	$20,580,000	79.8%	$517,100,000	$473,229,000	91.5%		$597,851,000		79.2%
1993	$28,819,875	$19,890,000	69.0%	$486,900,000	$433,327,000	89.0%		$555,220,000		78.0%
1992	$28,595,220	$14,619,000	51.1%	$430,100,000	$390,098,000	90.7%		$509,140,000		76.6%
1991	$25,013,437	$15,000,000	60.0%	$374,000,000	$360,301,000	96.3%		$476,397,000		75.6%

** final year FY 2004 is projected request*

EMPLOYEES RETIREMENT SYSTEM

Fiscal Year	Actuarial Request	Actual Funding	Percent of Request	Market Value of Assets	Actuarial Value of Assets (AV)	AV% of Mkt Value	Pension Benefit Obligation	Actuarial Accrued Liability (AAL)	% Funded Market Value *(MKT/PBO)*	% Funded Actuarial value (AV/AAL)
2004	$29,023,431	$26,645,619	91.8%	$1,040,927,987	$1,081,358,637	103.9%	$1,034,491,775	$1,107,634,000	100.6%	97.6%
2003	$24,715,309	$24,394,934	98.7%	$917,711,810	$1,025,469,088	111.7%	$968,014,164	$1,052,004,000	94.8%	97.5%
2002	$24,189,000	$23,788,282	98.3%	$892,221,769	$990,450,000	111.0%	$893,863,866	$1,017,129,000	99.8%	97.4%
2001	$19,679,398	$19,548,598	99.3%	$962,944,449	$954,821,000	99.2%	$882,725,301	$1,026,993,000	109.1%	93.0%
2000	$19,548,817	$19,012,608	97.3%	$1,058,889,568	$895,150,880	84.5%	$835,491,792	$967,064,000	126.7%	92.6%
1999	$23,268,000	$22,956,000	98.7%	$963,971,000	$804,970,000	83.5%	$745,531,000	$876,412,000	129.3%	91.8%
1998	$22,598,000	$23,426,000	103.7%	$914,960,000	$733,716,000	80.2%	$679,751,000	$804,501,000	134.6%	91.2%
1997	$24,098,000	$23,973,000	99.5%	$779,308,000	$639,128,000	82.0%	$634,794,000	$753,883,000	122.8%	84.8%
1996	$24,222,000	$21,442,000	88.5%	$638,674,000	$560,659,000	87.8%	$578,158,000	$664,173,000	110.5%	84.4%
1995	$29,245,000	$20,383,000	69.7%	$538,671,000	$480,049,000	89.1%	$541,597,000	$679,427,000	99.5%	70.7%
1994	$27,224,000	$21,791,000	80.0%	$473,120,000						

Source: JFO

Debt Management

Accomplishments

- **Vermont maintains AA+ bond ratings and has the best composite rating of any New England state.**
- **In Fiscal 2004, the State re-funded (refinanced) $136.9 million of its General Obligation Debt comprising over 30 percent of total outstanding G.O. debt. The refunding generated nearly $6 million of present value savings, or 4.36 % of the refunded bond amount. Gross savings of nearly $7.1 million will produce annual debt service savings of approximately $0.5 million per year over the next 14 years.**
- **Additional savings of $608,000 were achieved through a restructuring of the escrow securities associated with the re-funding.**
- **Approximately $57 million of bonds in this negotiated offering were sold to retail customers predominantly residing in Vermont. By placing so many bonds with Vermont investors, the need for a subsequent Citizens Bond offering was eliminated.**
- **The Capital Debt Affordability Advisory Committee (CDAAC) recommended raising the State's annual bonding level nearly 10% to $45 million in the next fiscal year. That would be up from $41 million this year. A $45 million level next year will allow Vermont to maintain its debt as a percent of personal income ratio (a key indicator for credit rating agencies) below the national median, something the State has worked hard to accomplish through several years of level or reduced bonding authorizations.**

Debt Management

Historically, the State Treasurer's Office, in conjunction with the Administration and Legislature, has set a course of maintaining modest levels of new authorizations of long-term debt and net tax-supported debt outstanding. The State's debt issuance and management process has been characterized by a conservative approach designed to reduce the level and cost of debt. As a result, bond issuance is currently at substantially lower levels than in the early and mid-1990s. This factor and continued improvement in the State's economic indices and financial condition over recent years have improved the State's debt ratios. The State's historical revenue surpluses resulted in full funding of the State's budgetary stabilization funds for the General, Transportation, and Education Funds over recent fiscal years, and contributed to significant pay-as-you-go amounts being employed for funding capital improvements. In addition, the State's practice of issuing debt with level annual principal installments has resulted in a favorable amortization rate. At approximately 80% within ten years, the State's bond payoff ratio has been favorably received by the rating agencies.

A major contributing factor to Vermont's respected debt management is the work of the Capital Debt Affordability Advisory Committee (CDAAC). The CDAAC completes an annual review of the size and affordability of the state tax-supported general obligation debt, and submits to the Governor and to the General Assembly an estimate of the maximum amount of new long-term general obligation debt that prudently may be authorized for the next fiscal year. The estimate of the committee is advisory, but historically has been adopted by the state as a bonding limit. CDAAC is made up of four *ex officio* members and one appointee of the governor. The State Treasurer serves as chair to the Committee. For fiscal years 2002 to 2004, CDAAC recommended a level of $39 million in new bonding each year. At its Fall 2003 meeting to consider the FY 2005 limit, the Committee recommended $41 million, encompassing a modest increase for inflation.

In September of 2004, the Committee met to establish a recommended bonding limit for FY 2006. The Committee carefully considered factors impacting the State's General Obligation Debt ratings as well as the need to fund critical state infrastructure projects.

Before arriving at a recommendation, the Committee considered debt management guidelines for the State. Prior debt guidelines established in the 1990s had been exceeded in recent years, which suggested the need for new guidelines going forward. Because Vermont is rated high AA+ by all three agencies, the State's debt is compared to AAA-rated states. An AAA rating is an attractive goal for a state because it offers a lower cost of capital to the State and favorably impacts the ratings and costs of capital for State Agencies such as the Vermont Municipal Bond Bank, Vermont Housing Finance Authority, and Vermont Economic Development Authority.

Chart# 5
CDAAC Guidelines

Debt Ratio	**Guideline**
Debt per Capita	Moody's AAA medians and means
Debt as Percent of Personal Income	Moody's AAA medians and means
Debt Service to Revenues	Six Percent or Less

Based on the above considerations, the CDAAC unanimously adopted the criteria outlined in Chart #5 above.

After a review of the impact of different levels of debt on the above ratios as well as on total net tax supported debt outstanding, the Committee unanimously voted to recommend that the FY 2006 State General Obligation Debt bonding limit be set at $45 million, a 9.8% increase from FY 2005.

The State reduced its new authorizations for general obligation debt from $60.9 million in Fiscal Year 1995 to $39 million in Fiscal Year 2004 (Chart #6). While fiscal years 2000 and 2001 are lower than the long-term trend, this is the result of the application of one-time revenues to offset the cost of debt. Approximately $2 million of revenues was used to pay for capital projects authorized in fiscal year 2000 (instead of the proceeds of bonds). Similarly, approximately $22 million of revenues was used to pay for capital projects authorized in fiscal year 2001. While representing increases for fiscal years 2005 and 2006, adoption of $41 million and $45 million annual debt authorization levels, respectively, is designed to balance the need to invest in State infrastructure with the objective of continually improving the State's debt profile.

By keeping new authorizations at moderate levels, the State of Vermont has reduced its total level of outstanding long-term debt (Chart #7). Net tax-supported debt outstanding reached a high of $536.2 million in 1997 and had been above the $500 million mark until fiscal year 2001. For June 30, 2004, net tax-supported debt outstanding has been reduced to $444.7 million. This is important given that the national trend (Chart #8) has seen a significant rise in aggregate general obligation debt levels. Based on the current debt levels recommended by CDAAC, outstanding debt should continue to decline.

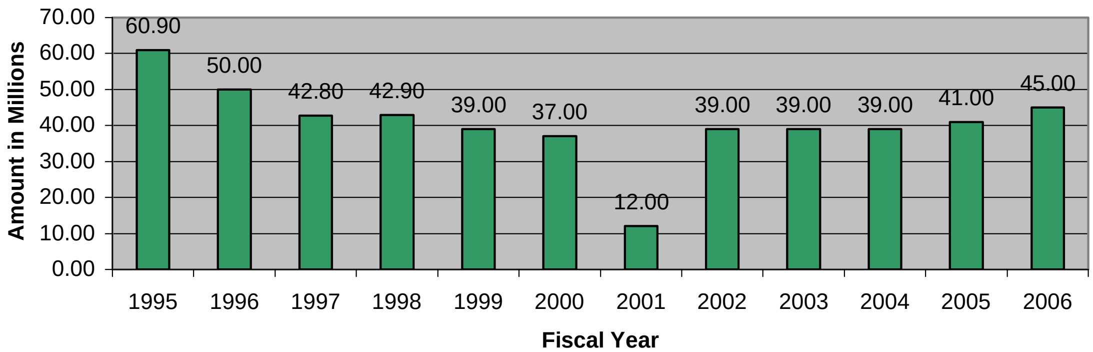
The CDAAC report projects net-tax supported debt to decline by 3.8% by 2015 (Chart #9). Total debt service, i.e., the amount appropriated to pay principal and interest on bonds, is calculated at $67.5 million for fiscal year 2005, versus $70.6 million in 2004. Future debt service payments will continue to fluctuate over the next decade and are not expected to show any steady decrease until fiscal year 2011, based on the current CDAAC model.

The State Treasurer's Office issued $42.2 million aggregate principal amount of general obligation bonds in February 2004. This included $3.2 million not issued from the FY 2003 authorization plus $39 million authorized for FY 2004.

The Treasurer's Office expects to issue all $41 million of FY 2005 authorized debt in February and March of 2005 in a competitive offering, followed by a negotiated "Citizens Bond" offering.

The State took advantage of low interest rates and also issued refunding bonds in the amount of $137.5 million in February 2004. These bonds refunded and refinanced a large portion of the State's General Obligation Bonds outstanding issued from 1993 through 2002. This refinancing resulted in a present value savings of 4.36%, or $5,966,554. The undiscounted savings were in excess of $7 million, providing average annual savings of approximately $500,000 per year through Fiscal Year 2018. Escrow restructuring following the issuance of the refunding bonds produced an additional one-time savings of $608,000.

Chart # 6
State of Vermont
Long-Term Debt Authorizations, FY1995-FY2006



Fiscal Year 2006 amount is CDAAC recommendation to the Governor and General Assembly.

Chart #7
State of Vermont
Net Tax-Supported Debt Oustanding, FY 1994- FY2004

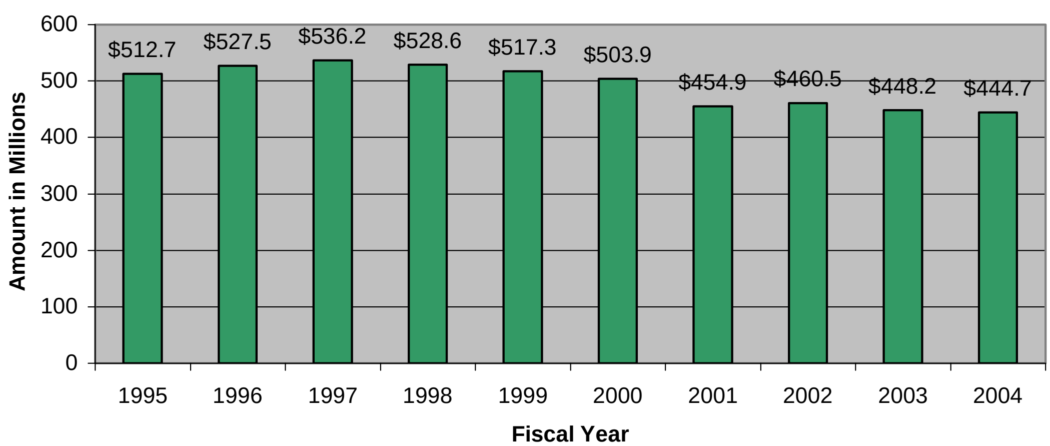


Chart #8
Total Net State (All States) Tax-Supported Debt Oustanding
Source: Moody's Investors Service

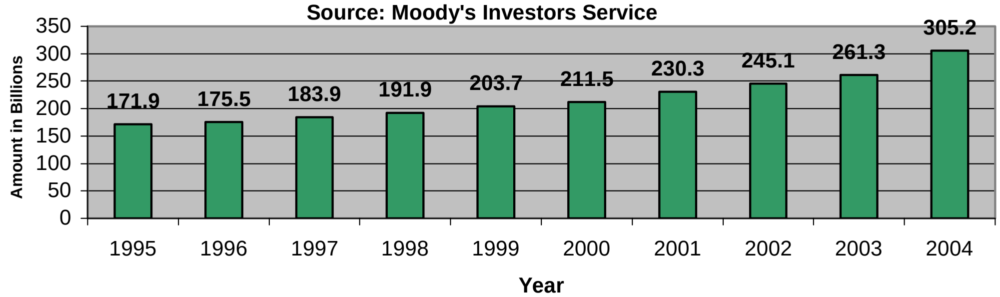


Chart #9
State of Vermont
Projected Outsanding Debt
Fiscal Year 2004-2014

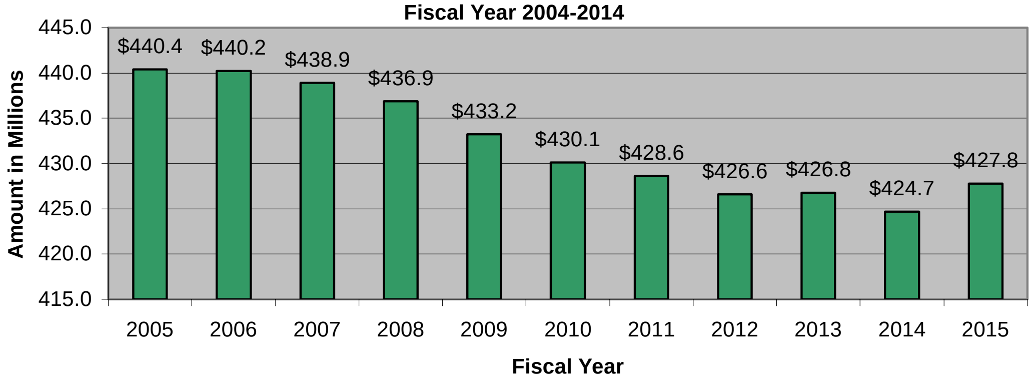
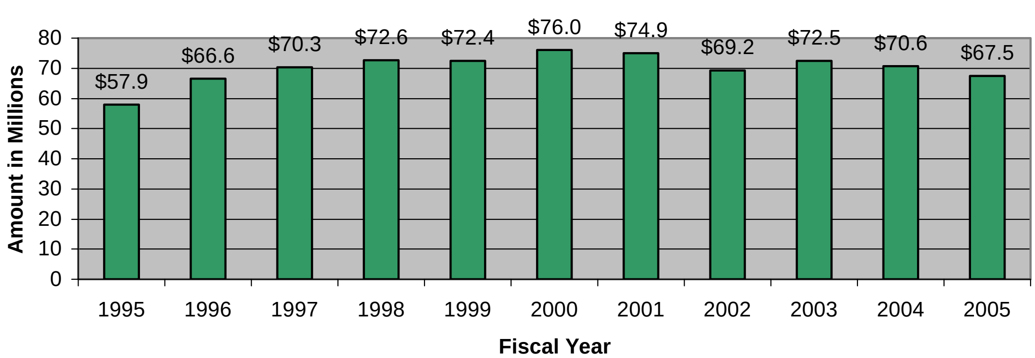


Chart #10
State of Vermont
Net Tax-Supported Debt Service FY1995-FY2005



Bond Rating

Vermont continues to enjoy the highest composite bond rating in New England (Chart #11) and has avoided the downgrades experienced by some states within the past three years.

As discussed above, whenever the State of Vermont enjoys a higher rating it enhances the marketing of its long-term debt. This generally results in a lower interest rate or cost of capital for borrowing. It is also likely to reduce borrowing costs for municipalities that issue debt through the Vermont Municipal Bond Bank or other borrowers issuing through other State Agencies, as well as to enhance the State's reputation in the municipal marketplace. A high credit rating is also attractive to business development as it is a sign of economic and fiscal stability.

Debt Statistics and Ratios

In assigning a rating to a State, the rating agencies consider several key indicators. In 1995, the State, through the Capital Debt Affordability Advisory Committee, established guidelines for the State as acceptable ratios for these key debt factors. As discussed above, these guidelines were revised in the most recent meeting of the CDAAC, as the State had essentially met or exceeded the 1995 guidelines. The Committee will continue to monitor the State's progress in meeting these revised guidelines annually and will consider them in formulating its recommendation of the total amount of long-term general obligation debt that the State can afford and should authorize each year.

1. *Debt Per Capita*: One of the key debt factors monitored by the CDAAC and the rating agencies is the ratio of the State's net tax-supported debt per capita. The new guideline adopted by the CDAAC establishes a target ratio of debt per capita at Moody's median and means for AAA-rated states. In 2004, the State's Debt per Capita was $724 versus the Moody's AAA median and mean of $691 and $823, respectively (Chart #12). The State's ranking versus all other states improved from 16th in 2003 to 24th in 2004. The higher the ranking figure, the lower a state's debt per capita is relative to all other states. While this represents a significant improvement, approximately one-half of all States have a higher (more favorable) ranking figure.

Currently for fiscal year 2005, the

Chart #11

New England General Obligation Bond Ratings

State	Fitch	Moody's	S&P
Connecticut	AA	Aa3	AA
Maine	AA+	Aa2	AA
Massachusetts	AA-	Aa2	AA-
New Hampshire	AA	Aa2	AA
Rhode Island	AA	Aa3	AA-
Vermont	**AA+**	**Aa1**	**AA+**

State's projected debt per capita is $709. Assuming a steady level of debt authorization and issuance of $45 million in future years, and employing the population forecast developed by Economic Policy Resources, the State's net tax-supported debt per capita is forecast to decrease each year through 2015.

2. *Debt as a Percentage of Personal Income*: An even more important credit factor for assessing a state's relative ability to pay its general obligation debt is the ratio of net tax supported debt as a percent of personal income. The new guideline adopted for this ratio is again to target Moody's median and mean for AAA-rated states. The State has steadily improved in this area, and the State's ratio of debt to personal income for FY'04 dropped to 2.5% versus Moody's median and mean ratios of 2.4% and 2.7%, respectively (Charts #13, #14). The State's ranking in its debt as a percentage of personal income improved from the 17th highest among the states in 2003 to 25th highest in 2004.

3. *Debt Service as a Percentage of Revenue*: The State remains in a strong position in fiscal year 2004 with respect to a third key debt ratio – debt service as a percentage of revenues. The new guideline used for this ratio states that projected annual State debt service on bonds should not be in excess of six percent of projected revenues in the combined General and Transportation Funds. The debt service as a percentage of revenues ratio was 5.5% as of June 30, 2004. This percentage is expected to be below 6% through 2015, assuming the issuance of $45 million of debt from FY 2006 through FY 2015.

Chart #12

New England States: Net Tax-Supported Debt per Capita

State	Debt per capita
Connecticut	$3,558
Maine	492
Massachusetts	3,333
New Hampshire	496
Rhode Island	1,385
Vermont	**724**

Note: The data is based on data as of 12/31/03, *not* fiscal year-end.
Source: Moody's Investors Service

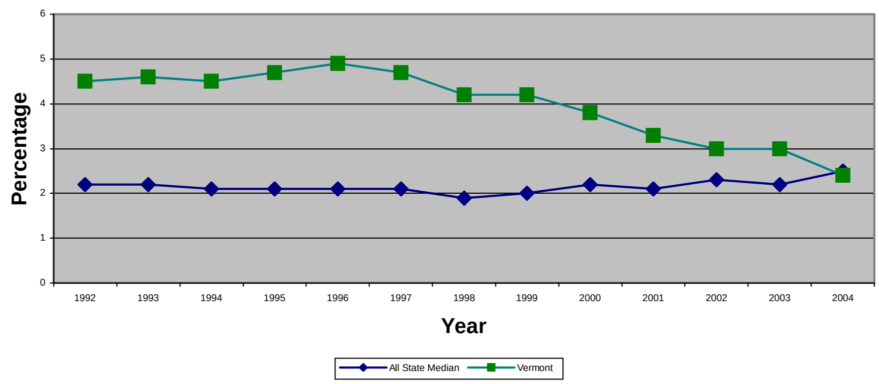
Chart #13

New England States: Net Tax Supported Debt as a Percent of 2002 Personal Income

State	Debt of Percent of Personal Income
Connecticut	8.4%
Maine	1.8%
Massachusetts	8.5%
New Hampshire	1.5%
Rhode Island	4.4%
Vermont	**2.5%**

Source: Moody's Investors Service

Chart #14
Net Tax-Supported Debt as a Percentage of Personal Income



Short –Term Borrowing

In the early 1990s, Vermont was issuing between $155 and $192 million of short-term debt obligations annually, not including $65 million in deficit notes. The State's strong cash position did not require the issuance of short-term debt in fiscal years 1999-2002 (Chart #15). The rating agencies have cited the reduction in short-term borrowing as a significant factor in their upgrades of the State's ratings. Besides the positive view held by the rating agencies, the State has saved significant money by avoiding interest charges on borrowed funds. As the national and regional economy placed additional stresses on governmental revenues, the State's cash position in fiscal year 2003 did necessitate the borrowing of $75 million. The State issued $75 million in revenue anticipation notes that matured on June 17, 2003. The notes bore a coupon rate of 2.5%, and interest on the notes was $1.5 million.

The State's cash position did, however, rebound quickly. In fiscal year 2004, projected cash shortages necessitated the borrowing of $48 million. On September 6, 2003, the State issued $48 million in revenue anticipation notes that matured on March 6, 2004, and carried a coupon interest rate of

1.18%. Due to this low interest rate, borrowing level, and relatively short borrowing period, interest on the notes was $283.3 thousand (Chart #16).

In addition to a lower dollar level, the period of cash need was considerably reduced, permitting full repayment in March. Typically, education payments to local towns and school districts occur in September and December, while tax revenues are collected later in the year, primarily April. By April 2004, the revenue flow was positive, and the State ended the year with a net increase in its cash position. Vermont began fiscal year 2004 with approximately $121.9 million in unrestricted cash or investments on hand and ended fiscal year 2004 with more than $232.4 million in unrestricted cash or investments, an increase of $110.5 million. While this cash balance does not bear a direct one-to-one relationship to fund balance, it indicates a very healthy rebound.

The State's annual cash flow, despite some systemic seasonal fluctuation, is expected to continue to improve. As reserves have been replenished over the past two fiscal years, the need for seasonal short-term borrowing is expected to continue to decline. In fact no borrowing was required for the September to December 2004 period, and no short-term borrowing is anticipated for the balance of fiscal year 2005.

Chart #15
Short-Term Borrowing
Fiscal Year 1994 -2005

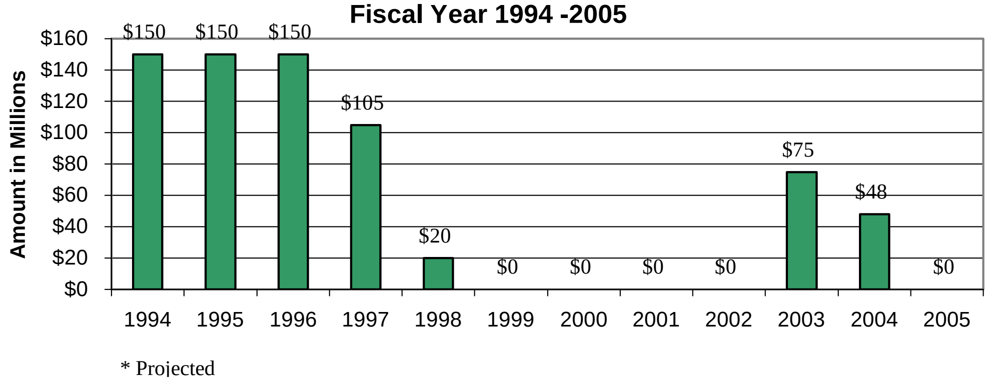
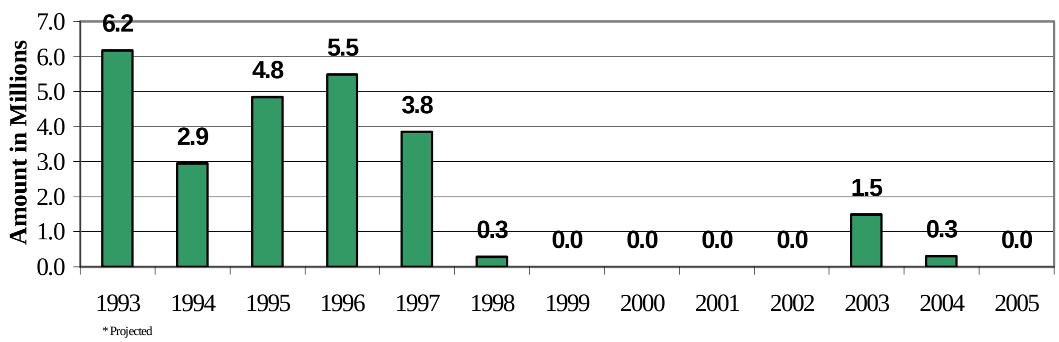


Chart #16
Interest Paid on Short-Term Borrowing
Fiscal Year 1993- 2004



Investments

Accomplishments

- **The three Vermont Retirement Systems and the State Treasurer's Office adopted a U.S. Proxy Voting Policy Statement and Guidelines in February 2004, effective March 1, 2004. These guidelines are designed to generate proxy votes that more effectively and consistently match State objectives.**

- **The three Vermont Retirement Systems have initiated major changes to their respective large cap domestic equity portfolios that involve increased use of enhanced indexing strategies. These changes, which are expected to be made in the first calendar quarter of 2005, are designed to produce superior rates of return within the asset class with less risk (volatility) and significantly reduced management fees.**

- **The Vermont State Employees' and Teachers' systems have agreed to consider a search for an equity manager that factors environmental considerations into its security selection for reasons of both investment return and social responsibility.**

- **Under legislative authority, the State Treasurer's Office invested $100,000 in a one-year promissory note with the Vermont Community Loan Fund. This loan serves the dual purpose of providing a good return to the taxpayers of Vermont as well as aiding certain underserved business and other borrowers by providing access to capital.**

- **The Treasurer's Office designed and implemented a program to invest a significant portion of Vermont's short-term cash in Vermont Banks. Previously, such funds were invested primarily in government agency securities, high quality corporate commercial paper, and money market accounts at large financial institutions. The new *Treasurer's Bank in Vermont Program* is consistent with an ongoing effort by the State Treasurer's Office to support Vermont-based financial institutions when acceptable rates of return can be achieved. As of December 31, 2004, $29 million was invested with banks with branches in Vermont.**

- **Fiscal Year 2004 investment returns were 15.7% for the VSTRS and VSERS and 14.87% for VMERS. All three systems continue to outperform the majority of public pension plans.**

Investments

Pension Fund Investments

The State Treasurer's Office administers the investment policies and strategies adopted by the Boards of the Vermont State Employees' Retirement System, the State Teachers' Retirement System of Vermont, and the Vermont Municipal Employees' Retirement System. The three systems had combined assets of nearly $2.5 billion on June 30, 2004. Asset levels have continued to rise on a long-term trend consistent with national trends in pension portfolios. The growth in assets is displayed in Chart #17 below.

In Fiscal Year 2004, investment returns improved significantly for the three principal Vermont Retirement Systems to 15.7% for both the Vermont State Teachers' Retirement System (VSTRS) and the Vermont State Employees' Retirement System (VSERS), and 14.8% for the Vermont Municipal Employees' Retirement System (VMERS) (Chart #18). Asset levels also increased, as investment return is a major contributor to the overall asset growth.

For the ten years ended June 30, 2004, the median public retirement plan in the United States had an average annualized total return of 9.7%, compared with 9.9% for VSERS , 10.6% for VSTRS, and 10.8% for VMERS. Vermont's retirement pension plans have and continue to outperform the majority of public pension plans.

Asset allocation is essential to the investment performance of the plan. In order to insulate the portfolios from short-term market fluctuations, the three pension systems diversify assets across a broad group of asset classes, which enables each portfolio to maintain stability through market cycles of the different asset classes. Each system's assets are invested in stocks, bonds, and real estate, with an additional small allocation to alternative investments, such as venture capital partnerships (Chart #19).

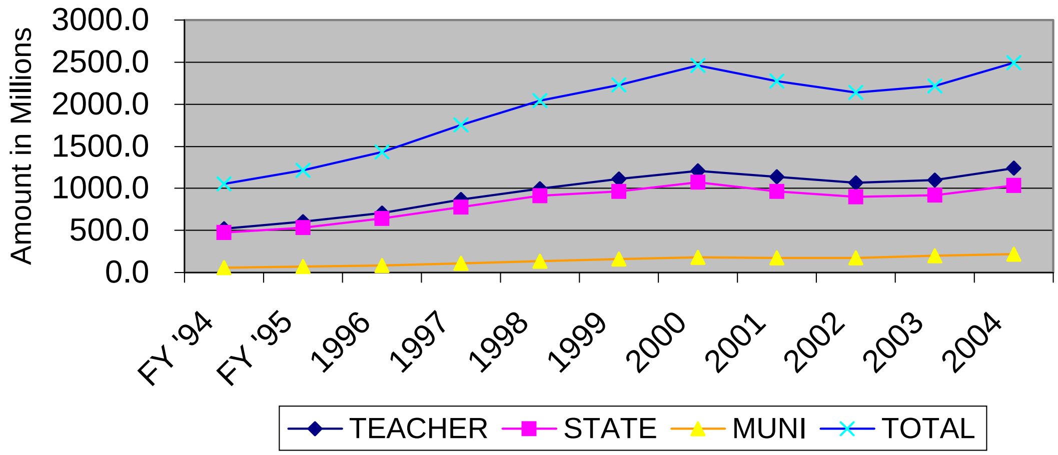
Investment in equity securities (common stocks) includes both the right and the responsibility to vote on matters presented through shareholder proxies. A coordinated voting policy on behalf of the three Vermont Retirement Systems and the Trust Investment Account will have a larger impact on corporate and environmental policies than would the absence of such a policy. For many years, proxy votes relating to State equities have been voted at the discretion of investment managers. This has in many instances allowed for votes on the same proxy matter to be different which cancels out the potential effects of each. Furthermore, the State and its Retirement System boards often have a view divergent from investment managers as to what is truly in the long-term best interests of Vermont.

In Fiscal Year 2004, a joint committee of the three Vermont Retirement Systems and the State Treasurer worked together to create and adopt a proxy policy and guidelines to guide our domestic equity investment managers in proxy voting on behalf of Vermont. The State's U.S. Proxy Voting Policy Statement and Guidelines was adopted, effective March 1, 2004.

The Policy's corporate governance guidelines include voting policies relating to boards of directors, auditors, shareholder rights, and executive and director compensation. The Policy's corporate responsibility and accountability guidelines include voting policies on environmental issues such as global warming and environmental reporting as well as workplace issues such as equal employment opportunities, human rights and labor codes. A copy of this policy may be obtained on the Vermont Treasurer's Web site.

The consultant was also engaged to conduct bi-annual reviews of votes recorded for U.S. domestic equity managers. As expected in the first year of policy implementation, the first audit of proxy votes cast in the first half of calendar 2004 revealed varying levels of policy compliance, including several firms with incorrect votes of less than 10 percent and other firms with incorrect votes in excess of 50 percent. With the audit information, the Treasurer's office has the ability to work with firms that are not voting consistent with the Policy to improve their voting in the future.

Chart #17
Growth of Pension Assets
FY '94 - FY '04



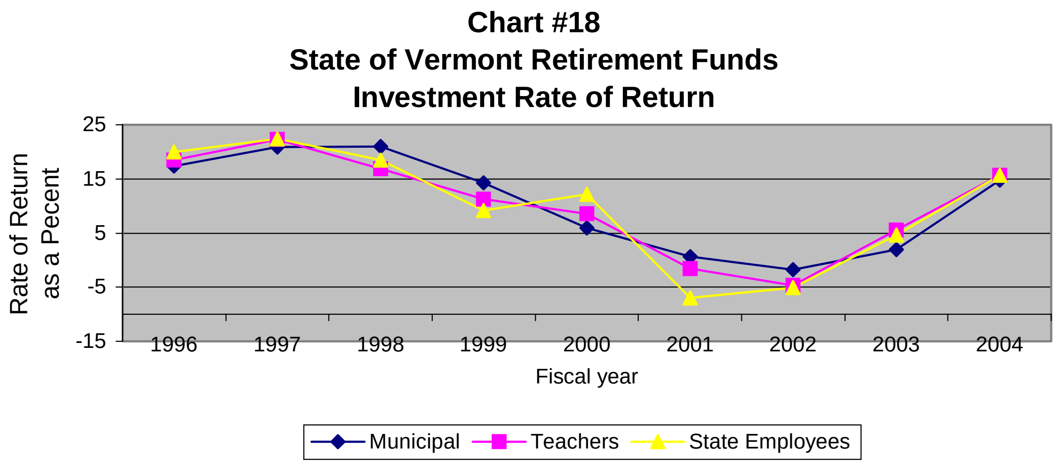


Chart # 19
Asset Allocation of Pension Funds As of June 30, 2004

Investment Category	Municipal	Teachers'	State
Domestic Equity	45%	45%	42%
Domestic Fixed Income	31%	12%	26%
International Equity	16%	17%	17%
Global Fixed Income	0%	17%	7%
Real Estate	6%	8%	7%
Other	2%	1%	1%

Common Investment Trust

The 2000 Legislature authorized the establishment of a trust investment account administered by the State Treasurer for purposes of investing restricted funds with non-expendable principal balances. As of June 30, 2004, the fund had a principal balance of approximately $39.3 million, of which $28.7 million was allocated to the Tobacco Trust Fund, $8.6 million to the Higher Education Endowment Trust Fund, and the remainder to various smaller trust funds. For FY'04, the fund had a total return of 7.6% versus the target return of 5.0%. For the same period, the S&P 500 Stock Index returned 19.1% and the Lehman Aggregate Bond Index returned 0.3%.

Higher Education Trust Fund

The 1999 Legislature established the Vermont Higher Education Endowment Trust Fund and appropriated $6 million for the creation and management of the fund by the State Treasurer. An additional $1 million was added to the fund in fiscal year 2001, and $635,881 at the end of FY'02. On June 30, 2004, the fund had a market value of $8,625,716. In August of 2004, the State Treasurer authorized the distribution of 5% of the average market value of the assets over the prior 12 quarters equally among the University of Vermont, the Vermont State Colleges, and the Vermont Student Assistance Corporation. Each received $135,482 to be applied as non-loan financial aid to Vermont students attending Vermont post-secondary institutions.

In addition to the above disbursements from the fund, the Vermont Commission on Higher Education Funding authorized the Treasurer to make available the additional 2% distribution of $162,579 to be divided equally between the University of Vermont and the Vermont State Colleges for application to their respective permanent endowments. In FY'05, the additional endowment allocation will be $81,289 for each institution, provided that it is matched on a two-to-one basis by external donations for endowment purposes by the end of the fiscal year. A copy of the State Treasurer's Annual Report to the Commission is attached as Appendix B.

Tobacco Litigation Settlement Fund and the Tobacco Trust Fund

In November 1998, Vermont was one of 46 states to enter into a settlement agreement with four major tobacco companies. The State's estimated share of settlement payments at the time was expected to total $806 million over the first 25 years of payment, with an additional $156 million of strategic contribution payments to be paid between 2008 and 2017. To date, the State has received payments that total $145 million.

Pursuant to the Agreement, the expected settlement amounts are adjusted for inflation and the effect of any decreases in the sale of tobacco products to the base year. To date, these have accounted for a 10.5% decrease. It remains difficult, therefore, to predict the amount of the future payments due from the tobacco settlement that will be received by the State.

In fiscal year 2000, the Vermont Legislature established a Tobacco Litigation Settlement Fund to be administered by the State Treasurer. For fiscal year 2005, the Legislature appropriated $17.25 million (the same as fiscal years 2001, 2002, 2003, and

2004) to healthcare services. A total of $4.67 million was appropriated to programs in the Health and Education Departments for tobacco enforcement, prevention, and education programs. Additionally, $4.65 million was appropriated to substance abuse and youth protection programs in the Agency of Human Services. The remainder of the receipts is earmarked for the separately established Tobacco Investment Trust Fund, a trust established to eventually endow the education and prevention programs. Such remaining receipts were transferred to the Tobacco Trust Fund at the end of FY'00, FY'01, and FY'02. The receipts remaining at the end of FY'03 were not transferred to the Tobacco Trust Fund but were instead transferred to the Health Access Trust Fund. Of the receipts remaining at the end of fiscal year 2004, $600,000 was transferred to the Health Access Trust Fund prior to year end, and the balance remained in the Tobacco Litigation Settlement Fund. The Health Access Trust Fund balance at June 30, 2004, was $23.6 million.

Vermont Veterans' Home

By legislative act, the Vermont Veterans' Home was required to transfer its endowment fund to the State Treasurer. In the fall of 2001, the Home transferred $455,441.85 to the State. The legislation allows the State Treasurer to invest these funds, if appropriate, with the long-term investments in the Investment Trust Account. The funds were invested with the State's short-term investments until a spending policy for these funds was established by the Board of Trustees for the Vermont Veterans' Home at its September 2002 meeting. A spending policy was adopted that allowed for transfer of the funds to the Vermont Trust Investment Account. Of this amount, $400,000 was deposited in the trust as of October 1, 2002. In November and December of 2002, the Vermont Veterans' Home received a bequest of $410,000 that was deposited into the trust account as a separately-named fund pursuant to the terms of the bequest.

As of June 30, 2004, the balance of the fund first contributed to the Trust Investment Account was $452,627, and the balance of the second (later) fund was $448,021, for a total of $900,648.

Chart #20

Vermont's Expected and Actual Receipt of Settlement Funds

Year	Expected	Actual
Fiscal year 2001	28.47	24.68
Fiscal year 2002	34.18	30.92
Fiscal year 2003	34.51	30.55
Fiscal year 2004	28.80	25.82
Fiscal year 2005	28.80	25.90*
Fiscal Year 2006	21.90	NA

*Estimated

Earlier in Fiscal 2004, a distribution of $25,000 ($12,500 from each fund) was made to the Veterans' Home. Effective July 1, 2004, an additional contribution of $75,000 was made to the second fund.

Short-Term Investing

The State Treasurer's Office manages the investment of the State's cash in its short-term investment program. The short-term portfolio earned $1.659 million in interest income in fiscal year 2004 on average available monthly balances of $163.2 million. Of this amount, $689,000 was credited to interest earning funds, and the balance of $970,000 remained in the general fund. The yield on the available cash in the portfolio was 1.02% for the year, which is 0.07% higher than the average three-month treasury bill auction rate of 0.95%. In prior years, this yield was calculated on balances inclusive of unavailable cash balances, which are deposited but uncollected funds. The Treasurer's Office solicits offerings daily from the institutional trading desks of a number of national and local brokers in order to achieve maximum rate of return and diversification in the portfolio.

Bank in Vermont Initiative

In August 2004, the Treasurer's Office initiated the *Bank in Vermont* Program to invest state funds on a predictable basis through CDs via a competitive bidding process in banks with branches in Vermont. The program is designed to be attractive to the wide range of banking institutions in Vermont, and is predicated on the belief that investing Vermont funds in Vermont, consistent with earning a competitive rate of return, is a good policy.

Banking institutions that wish to be placed on a list of eligible institutions must complete an application/ questionnaire. The responses are used to evaluate prospective candidates wishing to provide investment services for CDs, and to determine maximum levels of participation based on the bank's size, financial health, risk factors, credit ratings, and capital levels.

Banks so pre-qualified are then eligible to participate in a monthly competitive bidding process for certificates of deposits. Banks that have been pre-qualified are notified in writing and/or e-mail in advance of this schedule, and bidding is done on a Web site designed by the Treasurer's Office. A block of funds is set aside for the scheduled bid in specified time frames. Some of the funds may be short duration, while a portion is set aside for longer maturities, depending on the yield curve.

As of December 31, 2004, 15 banks have been pre-qualified to participate:

- Banknorth Vermont
- Charter One Bank, NA., a subsidiary of CFG
- Chittenden Trust Company
- Connecticut River Bank
- Factory Point National Bank NA
- First Brandon National Bank
- First Community Bank
- Lyndonville Savings Bank and Trust Company
- Mascoma Savings Bank
- Northfield Savings Bank
- Passumpsic Savings Bank
- Peoples Trust Company of St. Albans
- Randolph National Bank
- The Bank of Bennington
- Union Bank

Since its inception in August, $41.6 million in Certificates of Deposit (CDs) had been awarded through December. As of December 31, $29 million is invested in certificates of deposits of varying maturities with rates well above comparable Treasury rates.

Financial Operations

Accomplishments

- **Completed timely reconciliation of all bank accounts, now within 30 days of the accounting closing date on VISION.**
- **Improved procedures to work with user departments to resolve reconciling items.**
- **Improved controls over departmental bank accounts.**
- **Implemented positive pay services for our bank accounts, providing for increased preventive measures against presentation of fraudulent checks.**
- **Increased participation in electronic banking, reducing costs associated with the generation of payments.**
- **Consolidated many bank accounts, reducing administrative overhead.**

Financial Operations

Overview

The Financial Operations Division is the core operation for all money movement within the State. There are 23 core state bank accounts in two banks, five pension/retirement accounts, and two deferred compensation accounts from which funds are moved to fund the various transactions of the state. In addition, there are approximately 250 agency bank accounts for which this division exercises oversight.

This division, in concert with the Director of Finance and Investments, acts as the State's banker. This involves moving funds to cover payroll, vendor, and other disbursements, transferring receipts to interest-bearing accounts and investment instruments as quickly as possible to maximize return, and projecting cash needs so that fund movements can be efficient and cost-effective. Significant improvements in the timeliness of funds moving from department accounts were accomplished in this past fiscal year. The Treasury annually moves over $4.0 billion in both net receipts and disbursements.

This division also exercises administration over the Unclaimed Property Division (see next section).

In addition to moving the funds, this Division has significant responsibility with respect to the integrity of the State financial management systems. The movement of cash interacts with accounting. It is critical that staff members in the Division understand the accounting and financial management implications of their activity, and properly record them in the VISION system. In addition, all staff members provide guidance and consultative service to all state agencies and departments that deposit funds into state accounts at commercial banks to insure that all receipts of the State are deposited and accounted for in a timely and accurate manner. When the State made a change to the VISION system, it also necessitated a change in the accounting knowledge necessary to support the new system. Treasury staff training, knowledge, and skills have been upgraded, not only to meet our own business requirements but to assist the user agencies.

In addition to the altered accounting functions, the many new stresses and demands have changed the workload and complexity of the Division. The banking environment has been changed by economics and bank mergers, and also by the changing role of electronic processing — electronic funds transfers, automated clearing house (ACH) transactions, debit/credit card transactions, etc. There are operational and regulatory (banks, NACHA rulemaking, Federal Reserve) requirements associated with the changing industry, and it is incumbent on this Division to stay current with these and to work collaboratively with its business partners (Finance and Management, Tax, and Payroll).

Electronic Payments

The State Treasurer's Office encourages electronic funds transmissions of such items as vendor payments, payroll, welfare and other benefits. Most payments to municipalities are now handled electronically. In fiscal year 2004, the

Treasurer's Office processed approximately 1.62 million payments; of these, 37.0% were electronic transfers, up 9.5% over the previous fiscal year.

The Treasurer's Office continues to encourage State employees and retirees to authorize direct deposit of their paychecks and retirement checks. Direct deposit is a more efficient, less costly, and safer method by which to transfer funds. In December of 2004, 82% of retired municipal employees, 89% of retired State employees, and 92% of retired teachers received their monthly benefit payments via direct deposit. This is an increase from the December 2003 percentages of 77%, 88%, and 91% respectively. Currently 7,400 State employees, or 81% of the work force, have their biweekly earnings deposited directly to their bank accounts. This is up from 7,165, or 78%, from the prior year.

Joanne Montour assists Scott Smith from AOT at the Financial Operations Office front desk.

Reconciliation

Reconciliation provides a key internal control to detect posting errors or fraudulent activity. The Office of the State Treasurer has made concerted efforts to bring its bank reconciliations current by improving cash control and check fraud procedures with "positive pay." A series of joint reviews of the reconciliation process with the Department of Finance and Management assisted the Office of the State Treasurer in resolving important procedural and system issues. A formal tracking system to review reconciliation progress is now in place. Tracking of bank accounts has indicated that as of November 2004, reconciliation of all Treasury bank accounts is current, having been completed within 30 days of the close of the accounting period.

The Office has also made significant progress in resolving outstanding items on bank reconciliations and greatly reducing the overall number of reconciling items. A number of procedural changes for the Office of the State Treasurer have occurred, and staff continues to structure processes to insure that the various user departments/agencies are part of the reconciliation loop. Reconciliation between bank activity and the general ledger system is well documented and provides an excellent audit trail. Errors have been greatly reduced while making reconciliation timely.

The staffs of the State Treasurer's Office and the Finance and Management Department have taken pro-active steps to reduce the risks and improve the integrity of the data, timeliness, and reporting tools in the various systems. While the Treasury has clearly experienced a painful transition period, it has made significant progress in successfully resolving these issues.

Banking

Banknorth Vermont continues to serve as the State's master banking contractor. Bank personnel have worked thoughtfully and diligently with Treasury staff to provide new, secure services and processes with the goal of greater efficiency. In fiscal year 2004, EDI reporting was implemented for the Federal Fund and Depository accounts. This enables staff to obtain details of all incoming ACH deposits, thereby identifying the originator with an associated account number. Additionally, outgoing ACH returns for the payroll and retirement accounts can now be viewed on-line via e-Cash Manager, eliminating the need for paper reporting. The bank and the Treasurer's Office completed implementation of positive pay services for all Treasury and primary user department accounts (tax, child support, etc.) allowing for daily reconciliation of issued checks and eliminating encoding errors. All checks clearing the bank are verified against the check issue file on a daily basis to protect against potential fraud and forgeries. (An example of the effectiveness of this feature was evident in December 2004. The positive pay system prevented the posting of two fraudulent checks in the amount of $2,680.) Finally, check images are now available on-line for 90 days. This eliminates the need for staff to obtain CDs for the more recent check images that need to be researched. Treasury personnel have access to up-to-the minute account information, initiate wire transfers and automated transfers of funds, process stop-payments, utilize reporting functions, access check services, and be assured of secure messaging. All these features are complementing the effort to improve cash flow forecasting and funds management.

Auditors

Interaction with the Office of the Auditor of Accounts is essential to improvements in the State's financial reporting systems. The Auditor's office has offered financial reporting recommendations over the years that have proven helpful. In addition, every audit finding is taken seriously and, since the Treasurer's Office handles more than $4 billion of retirement and State funds annually, its Audit Compliance Division is charged with ensuring proper financial controls. The number of audit findings relating to the Treasurer's Office has declined significantly in recent years.

Act 68 Receipts

The Treasurer's Office monitors the receipt of payments mandated by Act 68 after the Departments of Education and Taxes have notified towns and school districts of their respective liabilities. In FY'04, all towns and school districts made their Act 68 payments.

As of December 15, 2004, all districts except one made their Act 68 payment that was due on December 1, 2004, as required. The Treasurer's Office conferred with the delinquent entity to encourage compliance, and collected interest on the late payment. Payment has since been received, obtaining 100% compliance. As in the past, unresolved delinquencies are referred to the Office of the Attorney General for collection.

Unclaimed Property

Accomplishments

- **Collected a record $19.2 million in unclaimed property in fiscal year 2004.**
- **Implemented improvements to the State's Web site permitting on-line generation of claims forms by customers.**
- **Increased transfers to the General Fund from $1.6 million in fiscal year 2003 to $7.8 million in 2004.**
- **Increased outreach to Vermonters to reunite them with their assets.**

Unclaimed Property Division

The primary function of the Unclaimed Property Division is to locate and return money and other property to its rightful owners or their heirs. This property is most often in the form of money, but it can also be stocks, mutual funds, and contents of safe deposit boxes. This property comes from many sources including banks, credit unions, corporations, utilities, insurance agencies, retailers, and governmental agencies throughout the United States. The State of Vermont acts as custodian to safeguard it until its rightful owners or their heirs claim it.

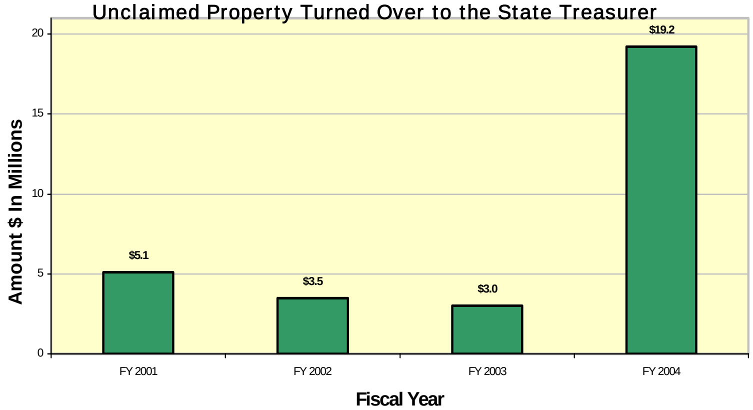
Currently, the State Treasurer holds more than $39.6 million of unclaimed property. For the fiscal year ended June 30, 2004, holders of unclaimed property turned over a record $19.2 million to the Unclaimed Property Division (Chart #21). That is $16.2 million greater than the same period ended June 30, 2003. The majority of this increase was related to legislative changes in the dormancy period, and to the demutualization of insurance companies. The Vermont General Assembly enacted legislation in 2003 which entailed a number of revisions to Chapter 13 of Title 27. The two most prominent amendments relate to the reduction in the dormancy period for most types of property, from five years to three years, and the development of special provisions directed at demutualized insurance companies. The effects of these legislative revisions have significantly improved the prospect that the unclaimed property in question will be reunited with its rightful owner. Additionally, the shorter dormancy period has increased State collections, at least in the short term.

While the rightful owner always has the opportunity to file a claim, a portion of the proceeds of the unclaimed property fund is transferred to the General Fund as revenue based on retention formulas. In fiscal year, 2004 the Treasurer's office provided the Legislature and Administration an estimated revenue of $5.6 million (middle of estimate with a low of $3.7 million and a high of $6.3 million). The actual transfer to the General Fund exceeded the revenue estimate of approximately $7.8 million.

The Unclaimed Property Division of the State Treasurer's Office processed 2,646 claims and returned a total of $2.143 million in fiscal year 2004, up from $1.543 million in claims paid in the previous year.

Chart #21

Unclaimed Property Turned Over to the State Treasurer



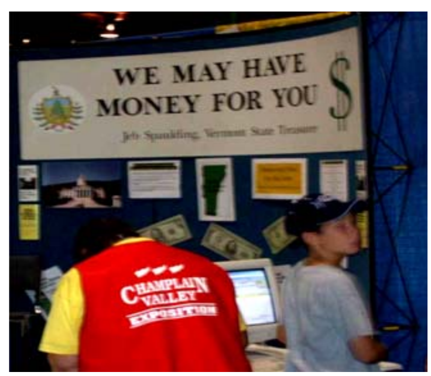
The average claim paid was $810.00. The largest claim paid was $105,000.

The Unclaimed Property Division has stepped up its outreach program to holders. Holder information is now posted on the Treasurer's Web site from which holders are able to print out reporting forms. The staff makes a diligent effort to locate missing owners and reunite them with their lost assets. The Unclaimed Property team consists of three full time employees in addition to the section coordinator. The help of town clerks and state legislators has also been enlisted, and the names of

Treasurer Jeb Spaulding explains the Unclaimed Property database to Rep. Ken Atkins and Rep. Tony Klein at the State House display in the spring of 2004.

owners have been posted on the Internet. Users of the State's Web site have the ability to download reporting and claim forms. Thousands of "owner" letters are sent each year. Owners' names are published annually in newspapers around the State as required by statute. The office staffs a booth at the Champlain Valley Exposition so attendees can look up their names on the computer database. As a result of staffing efforts at this year's Exposition, 718 people could have made claims for a total of $314,840.00, based on applications made at the booth. The results of these are already evident; approximately $3.6 million has been returned in the first six months of fiscal year 2005, ending December 31,2004. A reciprocity program with other states in order to return abandoned property to the state in which the owner most recently lived has also proved effective in returning property to its rightful owner as quickly as possible. It also allows holders to report only once instead of reporting to multiple states.

Finally, the software used to manage holder reporting, claims processing, and claims payment is called the Unclaimed Property Management System. UPMS is the most comprehensive and state-of-the art system available for states today. Some of the highlights of the system include: the ability to interact with Web sites, ease of portability to remote sites for public awareness sessions, the ability to import holder and owner data from external sources, the ability to interface with VISION, the State's accounting system, and increasing the accuracy of the data and reducing turnaround time of claims processing. In August of 2004, a significant interface between UPMS and VISION to automate the check-writing process was completed. It greatly increased the speed of the check-writing process and eliminated the duplication of work. This was



accomplished with a great deal of effort on the part of the staff at Wagers, the vendor for UPMS; the technical staff from VISION; and our own information technology staff.

Audit Compliance

Internal audit and control is broadly defined as a process, affected by an organization's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

1. Effectiveness and efficiency of operations.
2. Safety of assets.
3. Reliability of financial reporting.
4. Compliance with applicable laws and regulations.

Internal controls are tools that help managers be effective and efficient while avoiding serious problems such as theft, fraud, and mismanagement of resources; overspending; operational failures; and violations of law. Internal controls are the structure, policies, and procedures put in place to provide reasonable assurance that management meets its objectives and fulfills its responsibilities.

The Audit Compliance Division was created within the State Treasurer's Office five years ago. Since that time, the Division has conducted independent reviews of the diverse operations and controls within the office to determine whether acceptable policies and procedures are followed, established standards are met, and resources are used efficiently and economically in reaching the organization's objectives.

This is the third year of the new accounting system, VISION. With every new accounting system there is a learning phase. Given the decentralized nature of the VISION system, this necessitated a fresh look at internal procedures and controls at both the treasury oversight and user department level. The Division, along with the accounting staff and the Department of Finance and Management, has been active in reviewing, revising, and improving operations. The Division continues to perform a post-audit of the office's expenditures on a daily basis and is active in resolving variances in the bank reconciliation process.

The Division also plays a key internal control role with the Accounting Division in reviewing the more than 250 departmental cash accounts. A format for controlling these accounts has been implemented, and additional financial disclosure has been prepared for the State's Comprehensive Annual Financial Report (CAFR). Our review includes an assessment of the agency internal controls for reconciliation.

In addition, the Division has been actively involved in reviewing the work performed by the State's pension custodian, verifying data for incorporation in the state's VISION system. This includes preparation and review of the pension financial statements that must conform to the Government Accounting Standards Board (GASB) standards.

Technology Services Division

The Technology Services Division is committed to providing programming and technical support services to the Office of the State Treasurer for the purposes of enhancing efficiency, accuracy, and security, and contributing to the Office's commitment to a high standard of service to the State of Vermont, its clients, and its citizens. In performing this function, the Technology Division has a variety of responsibilities including: Developing software and systems for use by the office, maintaining and enhancing systems currently in use, performing periodic programming tasks, and maintaining the Treasurer's Office computer network.

The new Unclaimed Property Management System (UPMS) from ACS/Wagers Company was installed late in 2003. The premier unclaimed property administration software in the country, it is utilized by more than half the states in the US. This system has enabled many improvements in 2004, including automatic importing of holder and user files, interactive payment processing with the state's accounting system, and an improved remote facility for use at fairs and gatherings which features an automated claims collection system. The huge increase in volume created by demutualization and an expanded outreach program could not have been accommodated without these enhancements. Although the system is maintained by ACS/Wagers, Technology Services maintains a close relationship with the company and the Unclaimed Property Division.

The new and highly improved Office of the State Treasurer's Web site was deployed in May of 2004 (www. vermonttreasurer.gov). It provides updated and expanded information on cash management, unclaimed property, and retirement funds and services. There is also a new feature called *Tomorrow's Money*, sponsored in conjunction with the Bond Market Foundation, which gives useful money management advice to Vermonters.

The *Bank In Vermont* Web site was deployed in August to provide Vermont banks a convenient method for presenting weekly bids on short-term investments. An interactive Web entry system was deployed in September for Vermont State Teachers' Retirement System (VSTRS) payroll officers to submit their quarterly contributions reports. It is self-balancing and shows all bank remittances to date.

The Office of the State Treasurer's network underwent a major overhaul in November 2004, resulting in the replacement of two servers, the introduction of the Windows 2003 Server operating system, and a high-capacity tape backup system.

The long anticipated retirement re-engineering project was launched in 2004 with the creation of a limited services Project Manager position, and the issuance of an RFP for expert consulting services for a needs assessment. An RFP for a new administration software package with an integrated document imaging system will be issued later in fiscal year 2005. A more complete description of the project is included in the Retirement Division section of the report.

Legislative Reporting Requirement

Brandon Training School

Section 23 of Act 62 (the so-called Capital Bill) of the Public Acts of 1995 specifies that the State Treasurer notify the chairs of the Senate and House Institutions committees upon receipt of monies from the sale of the Brandon Training School property, as well as certain federal receipts associated with the Vermont Veterans' Home. For fiscal year ending June 30, 2004, the State has timely received amounts due from the federal government associated with the Vermont Veterans' Home, and has received $21,800 from the sale of property belonging to the Brandon Training School.

MacBride Principles

Act 50 of the Public Acts of 1989 specifies that the State Treasurer and the Retirement Boards compile a list of corporations that conduct business in Northern Ireland in which the State Treasurer and Retirement Boards have invested funds. Notifications from external investment managers listing such businesses are due in the Treasurer's Office on January 1 of each year, and these notifications are kept on file in the Treasurer's Office. The Act further requires that the Treasurer and the boards of the trustees of the Vermont State Employees' Retirement System and the Vermont State Teachers' Retirement System shall support the MacBride Principles worker equality and security issues through support of shareholder issues. The Treasurer's Office and the trustees comply with Act 50 by mandating MacBride Principles compliance through investment guidelines to be observed by investment managers. Recently adopted proxy voting guidelines adopted by the three Vermont Retirement Systems and the Treasurer's Office for US domestic equity managers also specify manager voting compliance with MacBride principles, which is subject to monitoring of exceptions.

Burma (Myanmar)

Act 13 of the Public Acts of 1999 specifies that the Treasurer shall implement the purposes of the Act by voting in favor of shareholder resolutions concerning an individual company's doing business with the government of Burma. In addition, the Treasurer shall separately notify the company that Vermont wishes to convey its grave concerns regarding the company's economic ties to the government of Burma. The Treasurer complies with this Act through measures including mandating compliance through investment guidelines that must be observed by investment managers. Recently adopted proxy voting guidelines adopted by the three Vermont Retirement Systems and the Treasurer's Office for US domestic equity managers also specify manager voting compliance including support of labor standards in connection with a company's involvement in Burma, and reporting on Burmese operations and activities.

Firefighters' Survivor Benefits

This was the second full year of existence for the Firefighters' Survivors Benefit Fund, established by the Legislature in 2002. A review Board administers the grant of a one-time monetary benefit to the survivor or survivors of a firefighter who dies in the line of duty or of an occupation-related illness. The Board met once during the year, developing and adopting policies, forms, and procedures to carry out its task. Thankfully, no benefit awards were required to be paid out to survivors this past year.

The fund currently has assets of $210,000.00. The Governor is requesting an additional $50,000 of funding in the current budget process.

Credit Card Payments

During the 2003 legislative session, an act was passed related to the statewide acceptance of credit and debit cards for the payment of fees and various revenues to the State. This past year, our office continued to work with departments to facilitate acceptance of credit cards. The Treasurer's Office contracts with Banknorth Merchant Services Group, a division of Banknorth Group, Inc., to provide credit and bank card services. Acceptance of credit and debit card payments is widely practiced in many agencies and departments as a method of payment of registration fees, licenses, penalties, fines, durable goods, park reservations, interest, and payment of taxes. As we continue with advances into the e-commerce arena, Vermonters should be provided with more convenient ways to deal with government. In addition to public convenience, electronic processing of consumer and business purchases for goods and services from the state improves governmental cash flows, offers greater financial security, and reduces the overhead costs associated with the handling of currency.

The Court Administrator's Office has been working with the Treasurer's Office to begin accepting credit/debit cards as a pilot program. The Court Administrator had targeted implementation in three courts on March 1, 2004, and in the Judicial Bureau by April 1, 2004. The three courts selected for the pilot are the Washington District Court for all fines and fees, the Chittenden District and Family Court for all fees and services, and the Essex Superior, Family, and District Courts for all fines, fees, and services. This project has been put on "hold" until the software that is used to produce court financial reports can be reprogrammed to account for credit card payments.

Credit Card Payments by Department

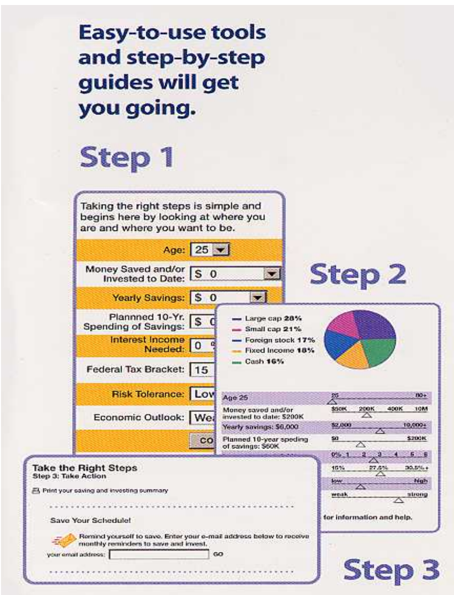
Department	YTD Net Sales 2004	YTD Fees 2004
VT Dept. of Liquor Control	$9,177,395.61	$316,375.97
VT Dept. of Motor Vehicles	584,071.10	10,893.54
VT Dept. of Taxes	2,025,422.90	44,699.46
VT Dept. of Fish & Wildlife	149,021.79	2,990.61
VT Dept. of Forests and Parks	833,446.02	20,467.07
VT Dept. of Health	121,278.99	2,663.57
Vermont Life Magazine	277,516.76	5,015.86
Vermont Judicial/Courts		3,980.00
Agency of Commerce & Community Development	465.00	
Total	$13,168,618.17	$407,086.08

Financial Literacy

The Treasurer's Office has a unique opportunity to assist Vermonters in areas of financial literacy. The office has had an ambitious agenda over the last year in exercising this important responsibility. Some of the efforts are highlighted in this section.

Tomorrow's Money

Tomorrow's Money, sponsored by the Office of the State Treasurer and the Bond Market Association, is a family of free Web sites dedicated to helping people start saving today for a secure tomorrow. The site provides guidance but does not permit selling or advertising. The Web sites are interactive, with step-by step guides to assist the customer.



Vermont Women & Money Conference

Women in Vermont had a unique opportunity to hone their money skills at a free conference held September 17, 2004, in Burlington. The State Treasurer's Office and the Vermont Women's Commission Education & Research Foundation hosted a free, day-long Vermont Women & Money Conference. The Conference focused on money management, retirement planning, and investment strategies for women of all ages and economic backgrounds and all levels of financial knowledge. The program was designed to address the unique financial issues women face in their work and personal lives.

According to statistics, women earn about 70 cents to every dollar earned by men, and two out of three working women have jobs that do not offer retirement plans. Statistics further show that an overwhelming 70% of America's four million elderly poor are women. These facts make it vital that all women become more informed and take steps to improve their financial future.

About 340 women attended the conference. The conference offered practical advice and tools to help participants achieve their personal financial goals, and featured a keynote session with Dee Lee. Lee is a well-known financial planner and expert for many television and radio stations across the country. She is the author of several books, including Let’s Talk Money and The Complete Idiot’s Guide to Retiring Early. Her newest, Women & Money: Your Personal Finance Guide, is a book for women and about women’s struggles with their finances, protecting their hard-earned assets, and developing a customized financial plan.

Other conference speakers included Christine Doreen Moriarty and Mary Jane McQuillen. Moriarty is a Certified Financial Planner with a background in accounting and small business management. In addition to her financial planning practice, she teaches classes at the University of Vermont. McQuillen is the Director of Social Research for Citigroup Asset Management. She is Vice-Chair of the Social Investment Committee, an affiliate group of the New York Society of Security Analysts (NYSSA).

In addition, workshops sessions were held on a variety of topics including developing a personal and family

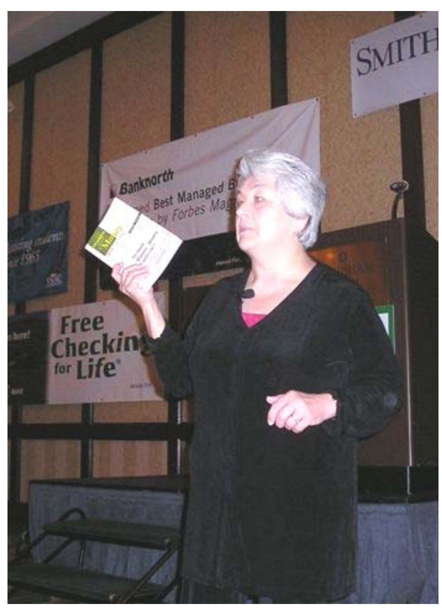
budget, life changes, retirement, investments, and debt management. Exhibitors provided valuable information to participants and included Smith Barney/Citigroup; Central Vermont Community Action Council; Dee Lee; Fidelity; Great-West Retirement Services; Merchants Bank; Banknorth; Champlain College; Vermont Woman; Northern New England Tradeswomen; Vermont Commission on Women; Vermont Businesses for Social Responsibility; US Small Business Administration; Vermont Development Credit Union; Vermont State Treasurer’s Office/ Unclaimed Property; Vermont Department of Banking, Insurance, Securities & Health Care Administration; and the Vermont Student Assistance Corporation/ Vermont Higher Education Investment Plan.

A steering committee assisted the Treasurer and Commission on Women's Education & Research Foundation in preparing for the conference and in outreach. We wish to thank its members: Tiffany Bluemle, Kathryn Boardman, Anita Bourgeois, Janet Bullard, Molly Dillon, Denise Fehr, Margaret Ferguson, Jean Gibson, Danielle Hogan, Wendy S. Love, Senator Hinda Miller, Mary R. Niebling, Alysia Perkinson, Sherry Prehoda, General Martha T. Rainville, Amanda Reismeyer, Ann Ryan, Judith Shailor, Debbie Sheridan, Sylvia Jarvis Smith, Kerin Stackpole, Esq., Kit Stone, Dawn Terrill, Lisa Ventriss, and Coralee Holm Zizza. Please see our Web site for more information.

Conference Co-Chairs Jeb Spaulding and Victoria Young review details with committee member Barbara Agnew.

Various State Agencies, such as BISHCA, represented here by John Cronin, provided useful information to attendees.

Richard Westman of VSAC provides information to an attendee on preparing for the cost of higher education.



Keynote speaker and author Dee Lee.

The State Treasurer's 2004 Team!

Front row: Wendy Lee, Lisa Gilman, Linda Bouffard, Tina Kawecki, Kristine Boswell, Deputy Treasurer Beth Pearce, and Joanne Montour.

Second row: Katie LaRaus, Jen Thivierge, Cheryl Taylor, Jane Lolax, Donna Holden, Nancy Gonneville (Vermont Bond Bank staff), Retirement Director Cynthia Webster, Gayle Rowe, and Irina Aylward.

Third row: Technology Director Dan Fine, Jessica Darling, Kitty Bolduc, Financial Operations Director Skip Perkins, Becky Brockway, and Barbara Agnew.

Fourth row: Ron Baldauf, James Quinn, Finance & Investments Director David Minot, Laurie Lanphear, Lane Safford, Dan Currier, Joanne Lilly, Mike Healy, Michael Clasen, Tammy Raycraft, and Treasurer Jeb Spaulding.

Missing from photo: Rachel Carriveau, Darryl Smith.

Staff Acknowledgements

The extensive accomplishments outlined in this report would not be possible without the support of our professional and hard working staff!

Each member of our team has made a considerable contribution to our mission; assisting our customers (taxpayers, employees, retirees, vendors) by the provision of cost-effective services. Below are some individual highlights.

RETIREMENT DIVISION STAFF

Kristine Boswell – Kristine is a very quick study who was recently promoted to fill a vacant Retirement Specialist II position. Having mastered the myriad rules and procedures of the state and teacher retirement systems, Kristine will soon be taking on the municipal system.

Michael Clasen - Michael joined the Retirement Division in May of 2004, and has already made significant improvements to the effectiveness, efficiency, and over-all morale in the office. He came with a wealth of experience in Vermont State Government, having previously worked for the Office on Aging and Disabilities and the Finance and Management Department, and most recently as Deputy Auditor of Accounts. Michael is an outstanding leader for the staff, and expertly manages the day-to-day operations like the true professional that he is.

Jessica Darling – Our newest employee, Jess is learning the ropes of the accounting side of our business and serves as primary back-up and assistant to Jen. Jess comes to our office with high marks and a great recommendation from the banking world.

Tina Kawecki – Having joined our office in 1999, Tina has worked her way up to a Retirement Specialist I position and is the division expert on the Municipal Retirement System. Tina is currently pursuing college course work to further her education and advance her career goals.

Laurie Lanphear - Our senior Retirement Specialist II, Laurie heads up our Member Services Unit. In addition to providing counseling services to prospective retirees, Laurie is the lead trainer on the State and Teacher Retirement systems. Laurie has been with our division since 1997 and is the “go to” person with any questions about the ins and outs of retirement.

Katie LaRaus – Katie transferred to our Employer Services Unit earlier this year and performed many of the duties of two positions for a number of months, including during our busiest months of July and August. Katie accomplished this feat with dedication and few complaints.

Wendy Lee – This past year Wendy has led the division’s efforts to automate the Teacher quarterly reporting process and was instrumental in the successful launch of the new Web-based Teacher reporting system. Thanks to Wendy’s diligence, persistence, and experience, we now have 308 school districts and supervisory unions reporting their teacher information via the Web.

Tammy Raycraft – As the primary front office staff person, Tammy is responsible for answering the phone, processing the mail, greeting walk-ins, and making address and beneficiary changes. As the office's first point of contact, Tammy has a pleasant, helpful manner and knows who can best answer your questions if she can't provide the answer.

Cheryl Taylor – An integral part of our Member Services Team, Cheryl is our 2nd on-phones person who also coordinates the Single Deposit Investment Account. She is a very dedicated individual who prides herself on providing our customers with as much information as possible to allow them to make informed decisions.

Jennifer Thivierge - In addition to heading up our two-person Accounting Unit, Jen goes to great lengths to ensure all of the new retirees receive their first pension check as soon as all the paperwork is processed. She has been with the Division since 1997 and is responsible for keeping track of the multitude of financial transactions that occur on a daily basis.

Cynthia Webster - With over 20 years of service in the Division, there isn't much about retirement that she doesn't know. As the Director of Retirement Operations, Cynthia is a key adviser to all three retirement boards and provides guidance to the State Treasurer and the Legislative committees.

TECHNOLOGY SERVICES STAFF

Dan Fine - Dan is the director of Technology Services. He has worked for the State for 30 years and directly for the Treasurer's Office since 1991. His responsibilities include coordinating data processing systems development, supervising the Technology Services staff, and maintaining mainframe and network database systems for the Retirement and Accounting divisions. In 2004, he developed the mainframe side of a Web-based data entry system for Teachers' Retirement payroll officers, participated in the preliminary stages of the retirement re-engineering project, and wrote numerous enhancements to the mainframe retirement system, including expansion of salary fields and pension payroll state tax processing.

Lane Safford - As our Network Administrator II, Lane is responsible for all aspects of the Treasurer's computer network, including purchase and maintenance of hardware and software, performing upgrades, ensuring security, troubleshooting, and assisting the staff with problems and questions. He has been with the State since 1988 and the Treasurer's Office since 1998. Among his accomplishments: in 2004 he performed a major upgrade to the network, coordinated many improvements to the Unclaimed Property system (including a payables interface with VISION), and effected remote computing for staff and management.

Darryl Smith - As our Systems Developer II, Darryl performs the dual role of database programmer and Web developer. He came on staff in 2001. He was key in the development and deployment of the Treasurer's new Web sites with their attractive interface and improved functionality. He also implemented the Web entry system now used by Teacher Retirement payroll officers to enter their quarterly contributions reports. He has also improved the office's many internal systems by making them Web-based and by upgrading to the latest database technology.

FINANCIAL OPERATIONS STAFF

Ron Baldauf - The Division Accountant C, Ron quickly and efficiently identifies all cash transactions and accounts for all of these transactions in the financial management system. Ron has been with the Treasurer's Office since 2001 and is the primary contact for tracking all federal draw deposits for the State.

Becky Brockway - Becky has been very instrumental in resolving many of the historic problems in the State's primary depository account, and has set up new procedures to identify potential reconciliation issues with user agencies. Before joining our accounting staff in early 2003, Becky worked extensively with the Project VISION implementation.

Rachel Carriveau - An integral part of our reconciliation team, Rachel works extensively with the federal reimbursement, concentration, and credit card depository accounts. Rachel has made great strides in resolving long-standing reconciling item. She has been with the Division since 1999.

Dan Currier - As Assistant Director of Financial Operations, Dan oversees the timely completion of all bank reconciliations and assures that all unreconciled items are resolved within a reasonable period of time. Dan also backs up the investment function and has been instrumental in improving our cash projection methodologies.

Lisa Gilman - Lisa joined the financial operations division in the fall of 2003, and handles all outgoing wire and ACH payments with great efficiency. Lisa has become a valuable resource for issues that need to be researched and resolved within the VISION and banking systems.

Michael Healy - Michael came to work for the State in 1984 and has been with the Treasurer's Office for all of his 20 years. Michael assists in the payment process, works with check replacements, and provides office mail delivery. In addition, Mike is responsive to the needs of the other divisions within the office and offers his assistance frequently to help with unexpected work-loads.

Joanne Lilly - As our lead person in processing vendor, payroll, and pension pay cycles, Joanne continues to provide exceptional service to the State's suppliers, employees, and retirees. Additionally, she is responsible for payment processing for the entire Office. Joanne came to the Treasurer's Office in 1998 and has 16 years of service to the State.

Joanne Montour - Having joined our staff in 2001, Joanne undertook a project this past year to obtain 100% compliance with various fee collections from municipalities, working closely with Town and City Clerks/Collectors. In addition, Joanne reconciles all bank accounts associated with the retirement systems.

Skip Perkins - Skip is the Director of Financial Operations and supervises the movement of over $4 billion in cash over the fiscal year. He is responsible for many of the improvements in our electronic payment processes, improving the efficiency of our operations and serves as our liaison to Finance and Management on VISION and HRMS/ payroll issues.

UNCLAIMED PROPERY

Irina Aylward - Irina joined the unclaimed property team this October. A quick study in the claims process, she will shortly be moving to the holder compliance side of the operation, facilitating greater compliance with the unclaimed property law.

Kitty Bolduc – Kitty joined our unclaimed property staff this year, having worked previously in Retirement. She has been proactive in learning the claims process and providing expert help to customers.

Linda Bouffard- As our most senior member of the unclaimed property team, Linda has provided leadership to her peers and demonstrated considerably responsiveness to the customers' needs. This has been accomplished during a period of escalating claims volume.

EXECUTIVE STAFF

Barbara Agnew - Barbara serves as the executive assistant to the State Treasurer, Deputy Treasurer, and Director of Finance & Investments, as well as functioning as our department's personnel officer. She has played a significant role in enhancing the professional image of the Treasury. Barbara manages much of the office's long-term planning and has been successful in improving office policies and procedures.

Donna Holden - As our contracts administrator, Donna has streamlined procedures and improved the procurement process. She has also issued new processes for tracking investment manager compliance. Donna also assists the Retirement Boards by providing lead staff support to the disability claims appeal process.

David Minot - As Director of Finance and Investments, Dave took a lead role in our general obligation refunding and bond issues. In Fiscal 2004, the State refunded $136.9 million of its General Obligation Debt comprising over 30 percent of total outstanding G.O. debt. The refunding generated nearly $6 million of present value savings, or 4.36 % of the refunded bond amount. Gross savings of nearly $7.1 million will produce annual debt service savings of approximately $0.5 million per year over the next 14 years.

Beth Pearce – As Deputy Treasurer, Beth has brought a wealth of treasury experience and expertise to our office, gleaned from her years of service as a deputy treasurer for the State of Massachusetts and as a financial officer for municipalities in two other states. She has focused her energies on continuous improvement of our operations, and has day-to-day responsibility for all our divisions. Her reputation for competence, dedication, hard work, and good humor is spreading quickly throughout state government in Vermont.

Bill Norton's Retirement

Bill Norton joined the Treasurer's Office as Director of Audit Compliance in 1998. In that capacity he was instrumental in improving the operations of the Treasury, reconciling accounts, preparing pension and unclaimed property financial statements, and providing guidance on operations issues. Bill retired in October 2004 after 41 years of state service. We want to publicly acknowledge and thank Bill for his many years of service, and wish him all the best in his new endeavors.

Employee of the Year
2004

Gayle Rowe, the Treasurer's Office Employee of the Year, with Governor Jim Douglas, Treasurer Jeb Spaulding, and her supervisor, Skip Perkins, Director of Financial Operations, at the 2004 Awards Luncheon.

Gayle Rowe, an accountant in the Financial Operations Division, was nominated by the State Treasurer as the Department's Employee of the Year under the Governor's Public Service Recognition Program. Our nominee for the prior year was Laurie Lanphear of our Retirement Division.

Gayle was recognized for her exceptional performance over the past four years, most significantly for her diligence in resolving many of the issues with the simultaneous conversion of the state's general ledger/financial system and the banking system conversion. Gayle was responsible for resolving many of the problems in the vendor reconciliation over this past year. In addition, she has provided oversight on department banking accounts and assisted in the cash flow analysis.

Gayle has a widely-admired customer service approach to her job, and is recognized as both helpful and knowledgeable. She assists others during peak periods and is willing to take on new, critical tasks. The Accounting Division runs more smoothly due to her dedication and expertise.

Appendices

A. Pension Fund Financial Statements for 2004

B. Annual Report on the Higher Education Trust Fund.

C. Review of Pension Funding Status
Vermont State Teachers' Retirement System

State of Vermont
Pension Trust Funds
Combining Statement of Plan Net Assets
June 30, 2004
(with comparative totals for June 30, 2003)
(preliminary unaudited statement)

	Vermont State Retirement Fund	Vermont State Defined Contribution Fund	State Teachers' Retirement Fund	Single Deposit Investment Account	Vermont Municipal Employees' Retirement Fund	Vermont Municipal Employees' Defined Contribution Fund	Totals June 30, 2004	Totals June 30, 2003
ASSETS								
Cash and Short-term Investments	$ 32,511,135	$ 207,512	$ 33,894,083	$ 12,151,276	$ 6,773,986	$ 60,549	$ 85,598,541	$ 61,861,404
Receivables								
Contributions	2,191,439	100,583	1,833,865		1,558,008		5,683,895	4,059,113
Investments Sold	170,479,718		52,675,756		2,171,722		225,327,196	115,049,788
Interest and Dividends	5,276,219		5,230,371	962,090	952,607		12,421,287	11,193,440
Other Receivables	32,816				9,902,963		9,935,779	10,244,344
Total Receivables	177,980,192	100,583	59,739,992	962,090	14,585,300	-	253,368,157	140,546,685
Due from Other Funds	29,317		4,000,000		455,307		4,484,624	134,836
Investments								
Fixed Income	304,509,779		347,955,665	100,960,340	60,729,270		814,155,054	704,095,807
Common and Preferred Stock	574,113,513		766,760,685		39,015,024		1,379,889,222	1,272,036,650
Mortgages	2,069						2,069	15,410
Real Estate/Venture Capital	75,907,034		105,226,341		14,877,595		196,010,970	199,459,231
Mutual Funds	24,143,785	31,016,205			107,176,516	7,710,884	170,047,390	132,792,797
Total Investments	978,676,180	31,016,205	1,219,942,691	100,960,340	221,798,405	7,710,884	2,560,104,705	2,308,399,895
Prepaid Expenses	943,569	2,323	716,339				1,662,231	894,847
Total Assets	1,190,140,393	31,326,623	1,318,293,105	114,073,706	243,612,998	7,771,433	2,905,218,258	2,511,837,667
LIABILITIES								
Accounts Payable								
Investments Purchased	148,303,891		71,165,337	12,471,125	10,487,360		242,427,713	155,299,423
Due to Other Funds		23,558	335,333		5,759	119,974	484,624	134,836
Other	884,310	2,544	1,114,668		224,557	1,724	2,227,803	2,505,202
Accrued Salaries Payable	24,205		27,662		5,763		57,630	41,899
Total Liabilities	149,212,406	26,102	72,643,000	12,471,125	10,723,439	121,698	245,197,770	157,981,360
Net Assets Held in Trust for Pension Benefits	$ 1,040,927,987	$ 31,300,521	$ 1,245,650,105	$ 101,602,581	$ 232,889,559	$ 7,649,735	$ 2,660,020,488	$ 2,353,856,307

State of Vermont
Pension Trust Funds
Combining Statement of Changes in Plan Net Assets
For the Year Ended June 30, 2004
(with comparative totals for June 30, 2003)
(preliminary unaudited statement)

	Vermont State Retirement Fund	Vermont State Defined Contribution Fund	State Teachers' Retirement Fund	Single Deposit Investment Account	Vermont Municipal Employees' Retirement Fund	Vermont Municipal Employees' Defined Contribution Fund	Totals June 30, 2004	Totals June 30, 2003
ADDITIONS								
Contributions								
Employer	$ 26,645,619	$ 1,454,751	$ 24,446,282	$	$ 7,114,813	$ 498,750	$ 60,160,215	$ 52,380,128
Plan Members	13,716,264	592,028	21,088,345		6,507,268	505,279	42,409,184	36,992,076
Transfers from Other Pension Trust Funds	695,397	484,329	267,330		156,373	226,599	1,830,028	1,618,643
Other Contributions		223,483			1,968,921	3,328	2,195,732	17,664,477
Total Contributions	**41,057,280**	**2,754,591**	**45,801,957**	**-**	**15,747,375**	**1,233,956**	**106,595,159**	**108,655,324**
Investments								
Net Appreciation (Depreciation) in Fair Value of Investments	116,454,897	2,893,810	142,232,006	(3,271,092)	23,251,537	705,259	282,266,417	48,668,431
Dividends	10,532,919	751,811	12,121,207		1,566,090	160,447	25,132,474	24,469,494
Interest	14,600,150	2,149	16,411,433	5,191,670	2,904,408	535	39,110,345	40,275,814
Security Lendings Income	755,140		944,301		5,210		1,704,651	1,853,172
Other Income	190,321		526,692		52,629		769,642	300,694
Total Income from Investments	**142,533,427**	**3,647,770**	**172,235,639**	**1,920,578**	**27,779,874**	**866,241**	**348,983,529**	**115,567,605**
Less Investment Expenses								
Investment Managers and Consultants	3,528,718	3,510	5,165,240	280,129	503,628		9,481,225	8,395,535
Security Lending Expenses	578,157		745,354		4,425		1,327,936	1,416,944
Total Investment Expenses	**4,106,875**	**3,510**	**5,910,594**	**280,129**	**508,053**	**-**	**10,809,161**	**9,812,479**
Net Investment Income	**138,426,552**	**3,644,260**	**166,325,045**	**1,640,449**	**27,271,821**	**866,241**	**338,174,368**	**105,755,126**
Total Additions	**179,483,832**	**6,398,851**	**212,127,002**	**1,640,449**	**43,019,196**	**2,100,197**	**444,769,527**	**214,410,450**
DEDUCTIONS								
Retirement Benefits	44,637,116	1,858,099	55,246,342	6,826,052	5,694,080	173,494	114,435,183	104,644,799
Refunds of Contributions	942,700		574,113		999,113		2,515,926	2,430,218
Death Claims	229,257		137,693		111,130		478,080	242,090
Transfers to Other Pension Trust Funds	617,658		543,746		668,624		1,830,028	1,618,643
Operating Expenses	9,895,973	161,174	9,084,827		151,228	52,927	19,346,129	18,651,282
Total Deductions	**56,322,704**	**2,019,273**	**65,586,721**	**6,826,052**	**7,624,175**	**226,421**	**138,605,346**	**127,587,032**
Net Increase	**123,161,128**	**4,379,578**	**146,540,281**	**(5,185,603)**	**35,395,021**	**1,873,776**	**306,164,181**	**86,823,418**
Net Assets Held in Trust for Pension Benefits:								
Beginning of Year	**917,766,859**	**26,920,943**	**1,099,109,824**	**106,788,184**	**197,494,538**	**5,775,959**	**2,353,856,307**	**2,267,032,889**
End of Year	**$ 1,040,927,987**	**$ 31,300,521**	**$ 1,245,650,105**	**$ 101,602,581**	**$ 232,889,559**	**$ 7,649,735**	**$ 2,660,020,488**	**$ 2,353,856,307**

TO: Commission on Higher Education Funding

FROM: Jeb Spaulding, State Treasurer

RE: Annual Report on the Higher Education Trust Fund

DATE: September 15, 2004 (Revised December 30, 2004)

I am pleased to present the State Treasurer's fifth annual report on the Higher Education Trust Fund. This fund was established in the Office of the State Treasurer by Act No. 27 of the General Assembly in 1999 and was initially funded with an appropriation of $6 million. Additional appropriations include $1 million in 2001 and $635,881.49 in 2002. The Act was amended in 2001 to provide that in August of each year, the State Treasurer shall withdraw 5% of up to a 12-quarter moving average of the fund's assets and divide the amount equally among the University of Vermont, the Vermont State Colleges, and the Vermont Student Assistance Corporation.

During fiscal year 2004, the Higher Education Trust Fund dollar weighted return was 7.59%. This return compares to the Lehman Aggregate Bond Index return of 0.32% and to the S&P 500 Stock Index of 19.14% for the same period, and exceeds the Fund’s target rate of 4.96%. The 5% distribution available this year is $406,448.75 in total, or $135,482.92 each for UVM, VSC, and VSAC; the distribution made following Fiscal Year 2003 was $123,931.34 for each institution. $ (See Appendix A for quarterly market values and distributions for fiscal year 2004.)

Act No. 27 further provides that in August of each year, the Commission on Higher Education Funding may authorize the State Treasurer to make an additional amount equal to up to 2% of the fund's average assets available to UVM and the Vermont State Colleges for the purpose of creating or increasing a permanent endowment fund. The amount appropriated, however, cannot exceed an amount that would bring the fund balance below the $6 million initial appropriation plus any additional contributions to principal.

At its meeting last year, the Commission authorized this 2% appropriation in the amount of $148,717.61, or $74,358.81 each, for distribution to the University of Vermont and the Vermont State Colleges dependent upon a finding by the Commission that the terms of this appropriation has been met. Each institution was given until the end of fiscal year 2004 to match the appropriation by raising twice that amount, or $148,717.61, and to certify to the Commissioner of Finance and Management that it received private donations in the requisite amount and that the funds will be used to create or increase a permanent endowment at the respective institution. Letters regarding these certifications have been received by the Commissioner of Finance and Management.

After payments of $406,448.75 and $148,717.61, the balance in the fund at the beginning of fiscal year 2005 totals $8,070,550.45.

All principal contributions to date total $7,635,881.49 (see Chart #1). This represents the current minimum balance that must be maintained in the fund. The 2% distribution proposed for this year of $162,579.50 would leave a balance of $7,907,970.95 excluding any gains from investment activity in Fiscal Year 2005. If the committee authorizes this distribution, each institution's share will be $81,289.75, with a required match to be raised by each entity in Fiscal Year 2005 of $162,579.50. Chart #2 is a graphical depiction of distributions, including the recommended 2% distribution.

An accounting of the fund balances is provided below:

Ending balance FY 2003		$8,572,981.01
Contributions received FY 2004		-0-
Opening balance FY 2004		$8,572,981.01
Distribution August 2003		(511,264.15)
Income earned fiscal year 2004		285,000.03
Appreciation (Depreciation) FY 2004		308,284.62
Fees and Other Charges FY 2004		(29.284.70)
Balance June 30, 2004		$8,625,716.81
5% of 12-Quarter Moving Average June 30, 2004		$406,448.75
Distributions:	University of Vermont	($135,482.92)
	Vermont State Colleges	(135,482.92)
	Vermont Student Assistance Corporation	(135,482.92)
2% Income Available for Endowments from FY 2003		$148,717.61
Balance after distributions		$8,070,550.45
Addition to Principal		- 0 -
Opening balance FY 2005		$8,070,550.45
2% Income Available for Endowments from FY 2004 (requires institutional match FY 2005)		$162,579.50

I have attached a spreadsheet as Appendix B that shows the total return of the entire Trust Investment Account, of which the Higher Education Trust Fund at $8,625,716 (prior to cash distributions made in fiscal year 2005) comprises approximately 22%. The Tobacco Trust Fund comprises 73% of the account, or $28,721,777, and the remaining 5% is made up of eight small unexpendable trusts that total $ 507,787, the ANR Stewardship Fund at $528,130, and two Veterans' Home trusts totaling $900,648. Chart #3 displays the relative share of the Higher Education Trust Fund compared to the entire fund. Chart #4 identifies the major asset classes in the portfolio and their performance over the past four years.

As noted in Chart #5, assets increased slightly despite a second year in a row of zero contributions. Fixed income has been the principal source of total return over the life of the Fund due to a combination of asset allocation and market forces. However, the Fund's equity investments have provided a significant contribution to the Fund's performance for the most recent fiscal year. The asset allocation of the Fund at June 30, 2004, comprised 26.7% equities and 73.3% fixed income securities versus 23.6% equities and 76.4% fixed income securities, respectively, at June 30, 2003; thus the Fund's equity allocation continues to increase toward an approximately 70%-30% ratio in favor of fixed income securities. We continue to believe this overall asset risk allocation plan takes into consideration both the beneficiaries' long-term investment objectives and the distribution needs afforded by current income.

In summary, the investment performance of the Trust Investment Account continues to support the distribution requirements of the Higher Education Trust Fund. Going forward, distributions will depend on the ongoing performance of the Fund, and will require continued monitoring of the Fund's investment performance.

Please feel free to contact me if you have any questions or concerns regarding this report.

cc: Robert Hofmann, Commissioner of Finance & Management
Anne Winchester, Legislative Council

\Hiedfundsreport.904

Appendix A
Higher Education Trust Fund
Quarterly Market Values

	Balance 9/30	Balance 12/31	Balance 3/31	Balance 6/30	
Education Trust					
FY2002	$7,419,326.45	$7,661,387.97	$7,769,954.55	$7,779,947.25	
FY2003	$7,885,377.45	$8,175,418.30	$8,212,332.41	$8,572,981.01	
FY2004	$8,242,399.79	$8,505,386.89	$8,697,470.84	$8,625,716.81	
Twelve Quarter Average	**$8,128,974.98**				
5% Distribution 2004	**$406,448.75**				
VSAC		$135,482.92		Contributions	
UVM		$135,482.92			
VSC		$135,482.92		Initial	$6,000,000.00
				2001	$1,000,000.00
2% FY2003	**$148,717.61**			2002	$635,881.49
UVM		$74,358.81		2003	$0.00
VSC		$74,358.81		2004	$0.00
Balance after Distributions	**$8,070,550.45**			Total	**$7,635,881.49**
2% FY2004	$162,579.50				
UVM		$81,289.75			
VSC		$81,289.75			

Appendix B
Trust Investment Account
Total Return Analysis

MANAGER	Calendar Year 2001	Fiscal Year 2002	Calendar Year 2002	Fiscal Year 2003	Quarter Ended 9/30/2003	Quarter Ended 12/31/2003	Calendar Year 2003	Quarter Ended 3/31/2004	Quarter Ended 6/30/2004	Fiscal Year 2004	Portfolio Market 6/30//2004	Portfolio Percent 6/30/2004
DOMESTIC EQUITY												
Hanson Investment Management	**17.41**	**(7.78)**	**(18.01)**	**-1.89%**	7.09%	18.25%	**42.55%**	2.59%	-0.63%	**29.10%**	$5,388,663	13.7%
Prentiss Smith & Co.	**13.69**	**3.60**	**(7.35)**	**7.70%**	1.46%	6.64%	**18.17%**	1.23%	1.77%	**11.47%**	$5,100,275	13.0%
S&P 500	***(11.89)***	***(17.99)***	***(22.11)***	***0.25%***	*2.65%*	*12.18%*	***28.69%***	*1.71%*	*1.72%*	***19.14%***		*26.7%*
DOMESTIC FIXED INCOME												
NL Capital Management	**10.07**	**9.41**	**9.48**	**8.92%**	1.70%	0.39%	**5.43%**	2.21%	-0.84%	**3.48%**	$28,795,123	73.3%
Lehman Aggregate	***8.44***	***8.63***	***10.25***	***10.40%***	*-0.15%*	*0.32%*	***4.10%***	*2.66%*	*-2.44%*	***0.32%***		
TOTAL FUND DOLLAR WEIGHTED RETURN	**11.62**	**7.94**	**5.15**	**8.59%**	2.30%	3.47%	**11.24%**	2.14%	-0.48%	**7.59%**		
Total Fund Target	**6.57**	**3.94**	**3.29**	**9.23%**	0.52%	3.34%	**9.94%**	2.41%	-1.33%	**4.96%**		
TOTAL FUND MARKET VALUE	**$32.6**	**$33.3**	**$34.9**	**$37.3**	**$37.6**	**$38.8**	**$38.8**	**$39.6**	**$39.3**	**$39.3**	$39,284,061	**100.0%**

* Inception date 7/15/00

Chart #1

Higher Education Trust Fund
Fund Contributions

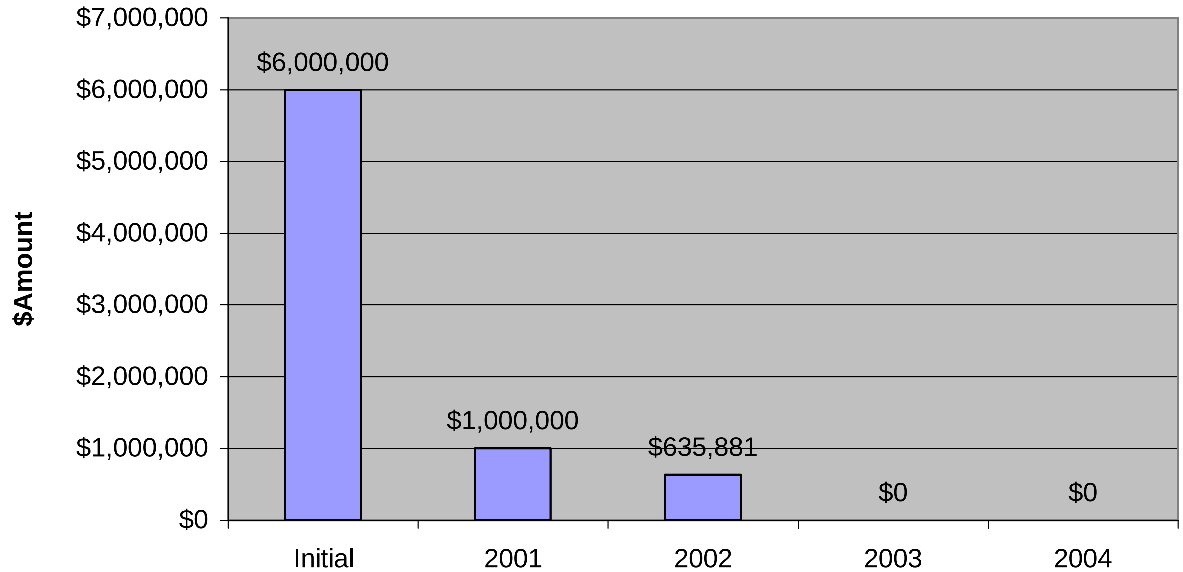


Chart #2

Higher Education Trust Fund
Distributions by Year and Type

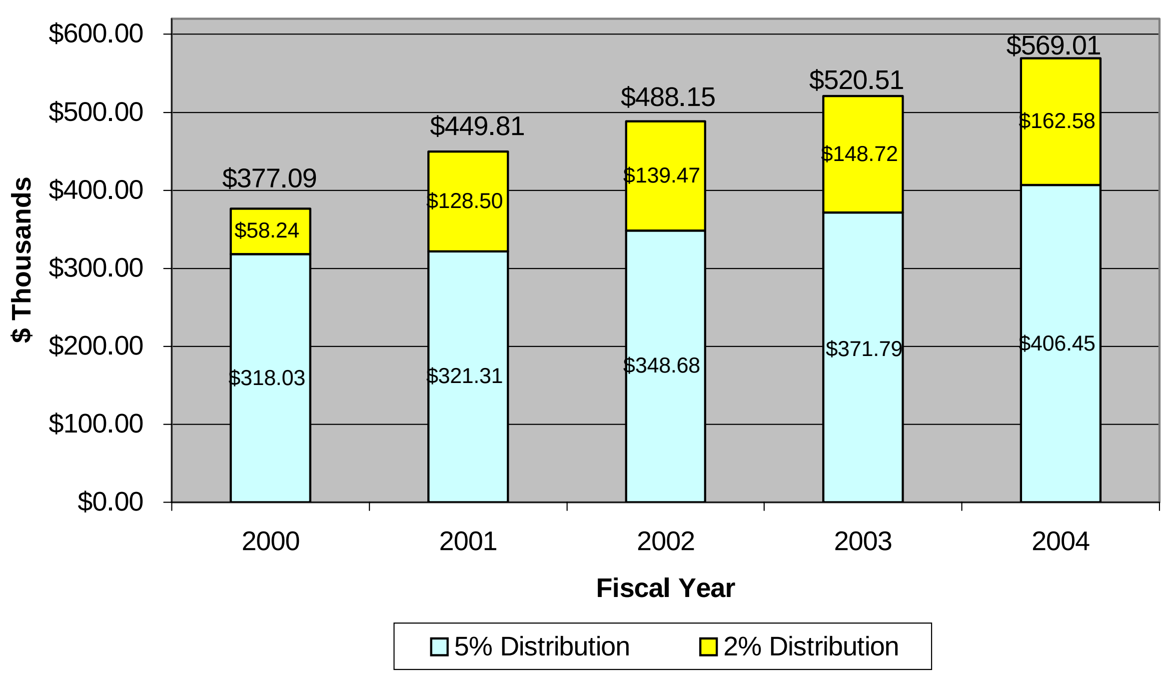


Chart #3
Common Trust Fund Breakdown as of June 30, 2004

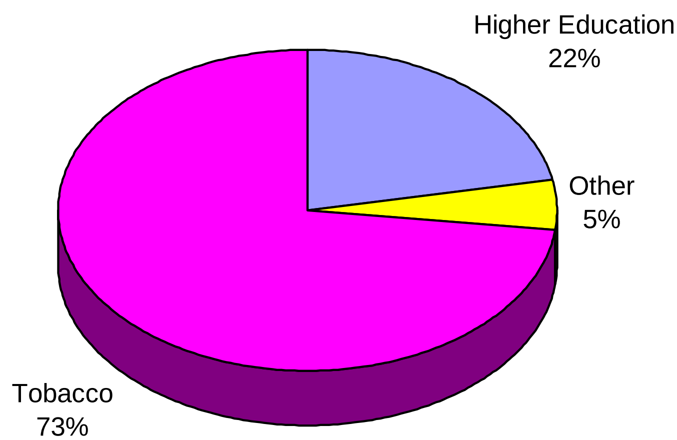
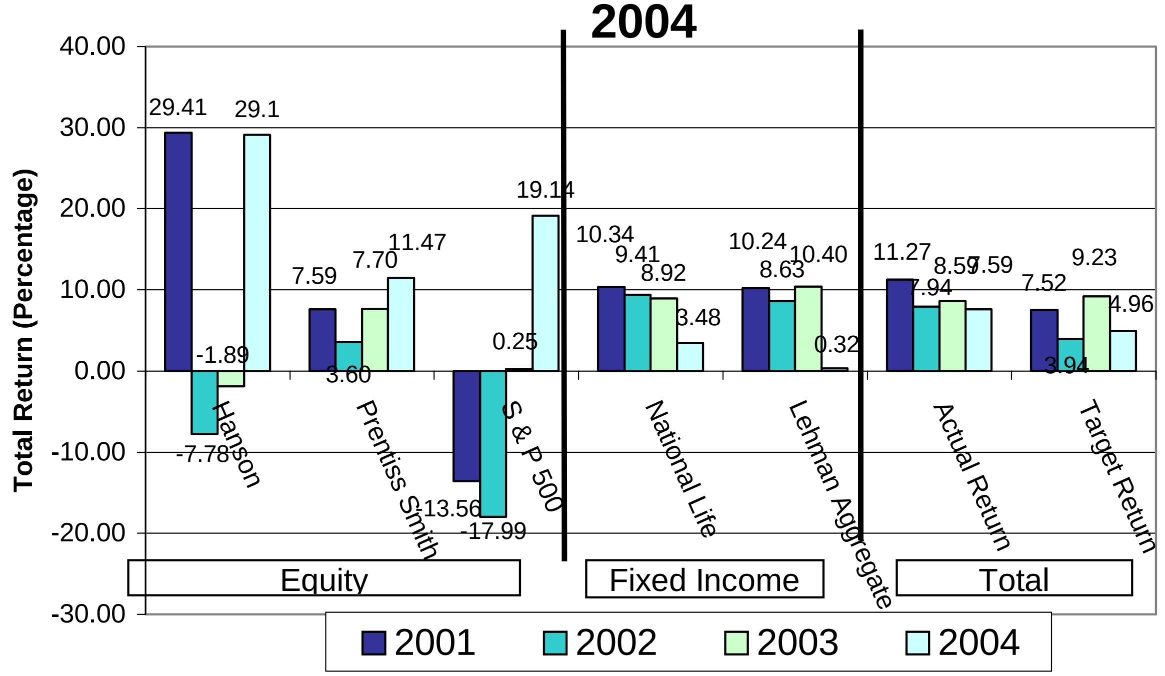


Chart #4
Higher Education Trust Fund
Total Return by Asset Class Fiscal Years 2001-2004

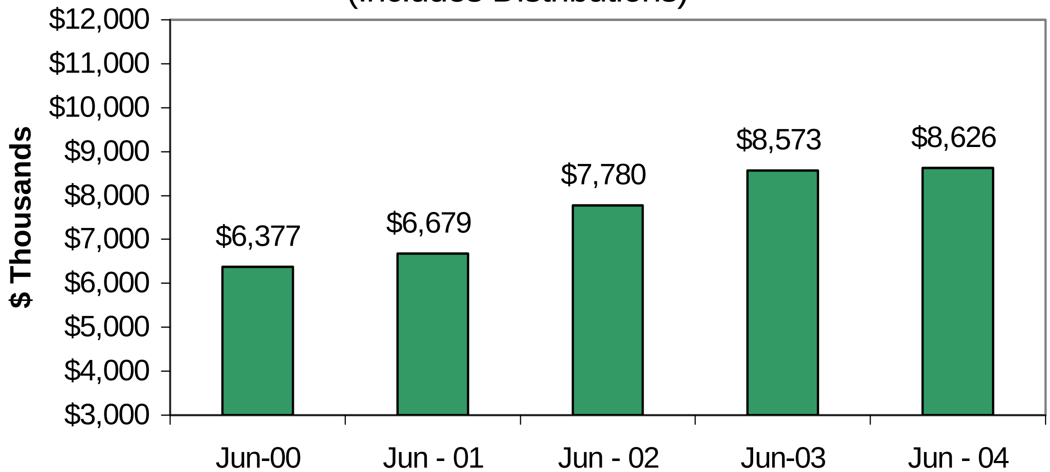


Note: Some performance figures are restated to reflect a uniform reporting methodology.

Chart #5

Higher Education Trust Fund
Asset Growth, 6/30/2000 to 6/30/2004

(Includes Distributions)



Review of Pension Funding Status
Vermont State Teachers' Retirement System

Jeb Spaulding
State Treasurer
January 2005

Pension Benefits are essentially IOUs to employees that accumulate while they are working and that are cashed in at the time of retirement. These benefits are also a partnership, since employees make ongoing contributions to the plan with the expectation that the employer will meet its obligations.

2

Who is responsible for benefit payments?

Public pension funds, unlike private or corporate funds, are not regulated by the Employee Retirement Income Security Act of 1974 (ERISA) and do not have back-up from the Pension Benefit Guaranty Corporation, as private corporations do, to provide a safety net to pay benefits in case of system deficiencies.

Public funds must ultimately turn to individual sponsors, in this case the State of Vermont, to make good on retirement IOUs.

3

The Bottom Line

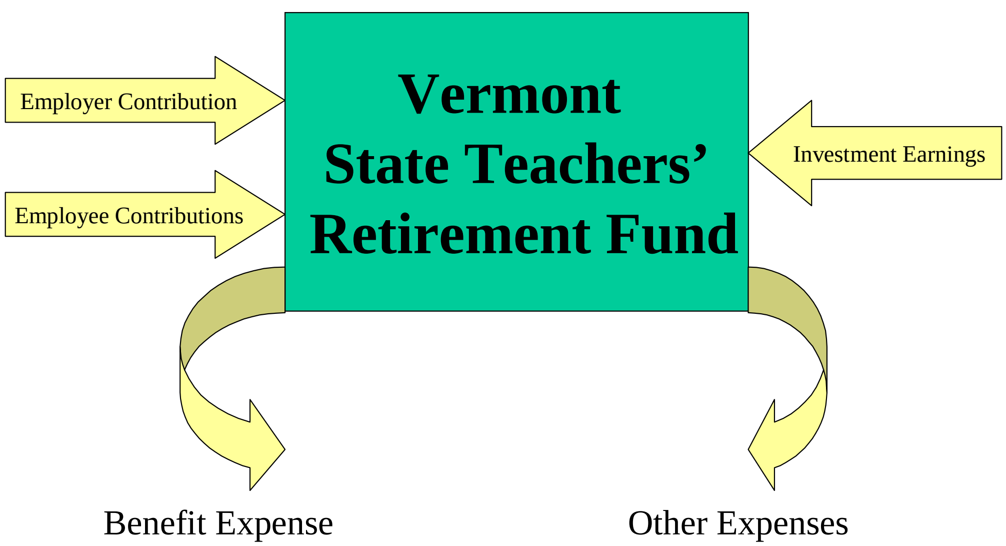
Fiscal Year	Actuary's Recommend	Actual Approp.
FY 2001	$20,970,278	$19,143,827
FY 2002	$22,146,880	$20,446,282
FY 2003	$28,279,810	$20,446,282
FY 2004*	$41,658,946	$20,446,282
		$ 4,000,000**
FY 2005	$47,714,318	$20,446,282
FY 2006	$49,923,599	

*The significant increase in the actuarial recommendation in FY 04 resulted in large part from the required five-year actuarial experience study.

**In addition to the base appropriation of $20,446,282, a "waterfall" allocation of $4,000,000 from excess revenues was appropriated in FY2004.

4

Pension Funding Model



5

Long-term Actuarial Funding of VSTRS

Year Ending June 30	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)
2004	$1,284,833	$1,424,662	$139,829	90.2%
2003	1,218,001	1,358,822	140,821	89.6%
2002	1,169,294	1,307,202	137,908	89.5%
2001	1,116,846	1,254,341	137,496	89.0%
2000	1,037,466	1,174,087	136,621	88.4%
1999	931,056	1,066,400	135,343	87.3%
1998	821,977	955,694	133,717	86.0%
1997	717,396	849,179	131,783	84.5%
1996	570,776	700,377	129,601	81.5%
1995	520,850	648,052	127,202	80.4%
1994	473,229	597,851	124,622	79.2%
1993	433,327	555,220	121,893	78.1%
1992	390,098	509,140	119,042	76.6%
1991	360,301	476,397	116,096	75.6%
1990	328,338	441,414	113,076	74.4%

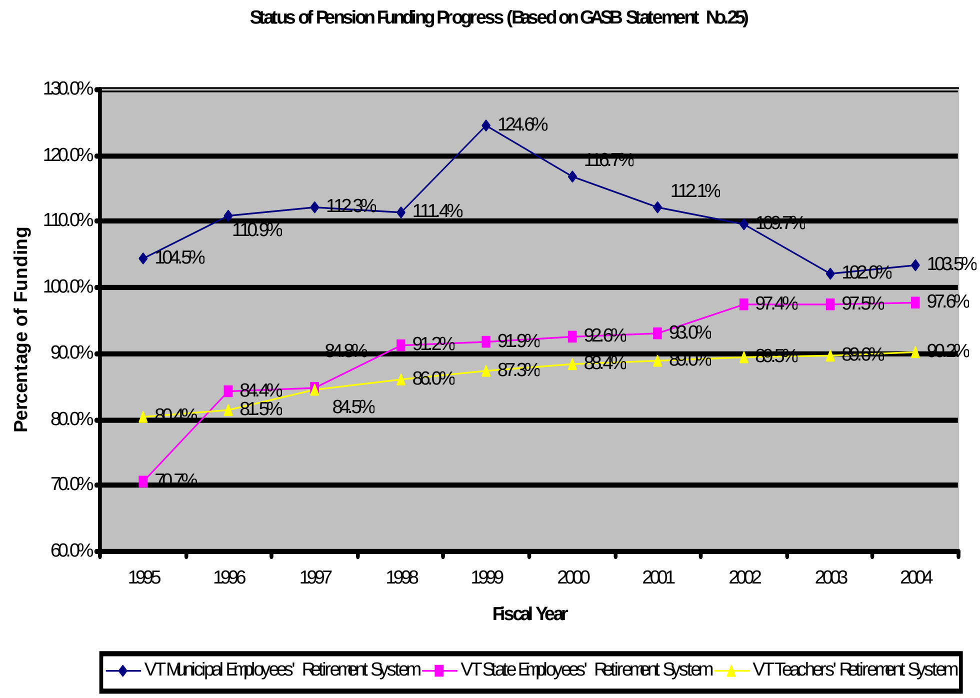
6

Pension Operations Summary

Vermont State Teachers' Retirement System

Category	Fiscal Year 2004	Fiscal Year 2003	Fiscal Year 2002	Fiscal Year 2001
SOURCES OF FUNDS				
Employee Contributions	$21,088,345	$18,820,703	$18,075,514	$16,350,020
Employer Contributions	$24,446,282	$20,446,282	$20,446,282	$19,143,827
Other Income	$267,330	$438,166	$121,238	$296,005
Investment Income	$166,325,045	$52,506,838	-$56,937,537	-$38,810,722
APPLICATION OF FUNDS				
Retirement Benefits	$55,246,342	$50,409,313	$46,624,879	$42,526,838
Refunds	$711,806	$1,109,174	$867,715	$1,089,403
Health/Life Insurance Expenses	$8,279,332	$6,634,738	$5,299,600	$4,194,215
Administrative Expenses	$805,495	$763,527	$663,545	$677,493
Other Expenses	$543,746	$702,568	$280,609	$441,354
Addition to Net Assets Held in Trust for Pension Benefits	$146,540,281	$32,592,669	-$72,030,851	-$51,950,173

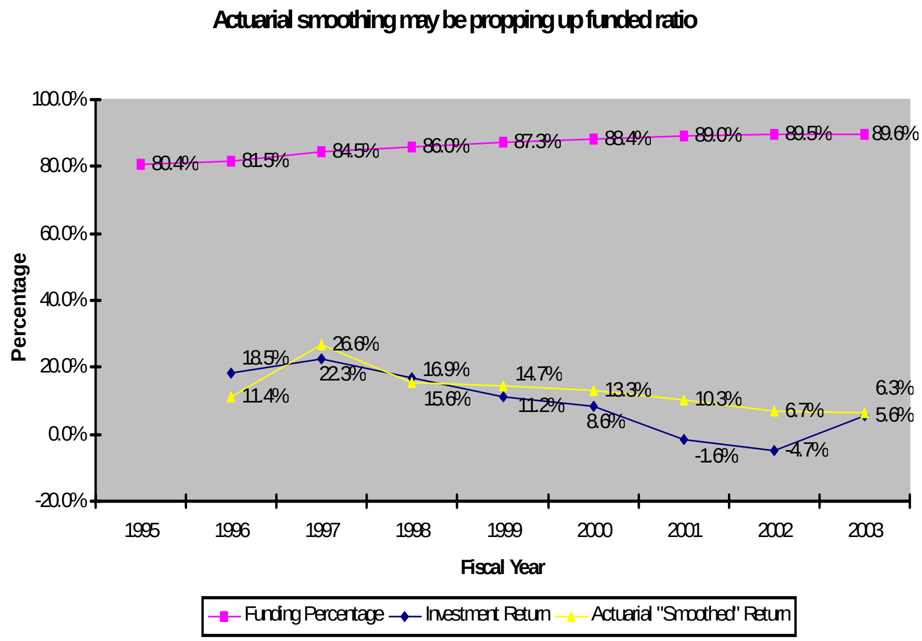
7



Long-term Investment Performance Of Vermont's Three State-Supported Retirement Systems

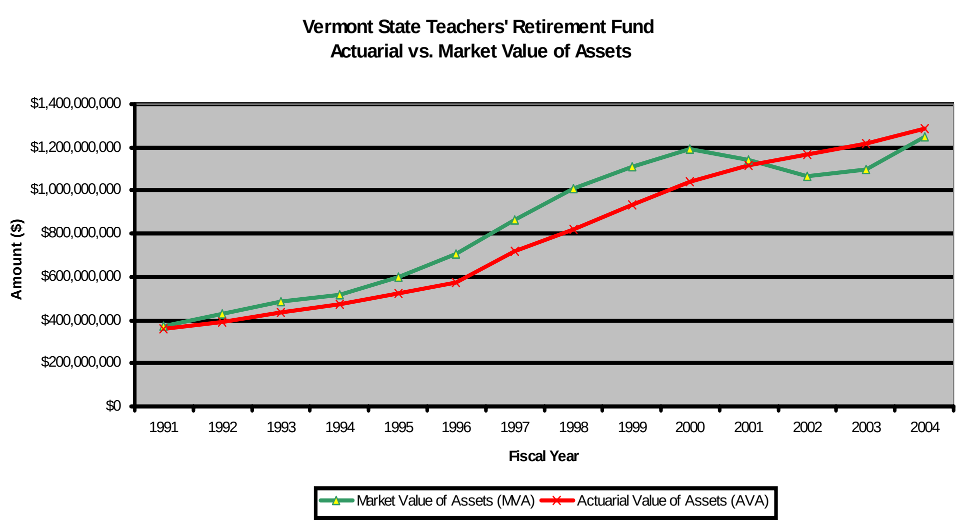
As of June 30, 2004

Retirement System:	Last 1 Year	Last 3 Years	Last 5 Years	Last 7 Years	Last 10 Years
Teachers Composite (Gross)	15.7%	5.2%	4.5%	7.1%	10.6%
Employees Composite (Gross)	15.7%	4.7%	3.7%	6.4%	9.9%
Municipal Composite (Gross)	14.8%	4.8%	4.2%	7.8%	10.8%
Median Public Fund	14.6%	4.4%	4.1%	6.7%	9.7%

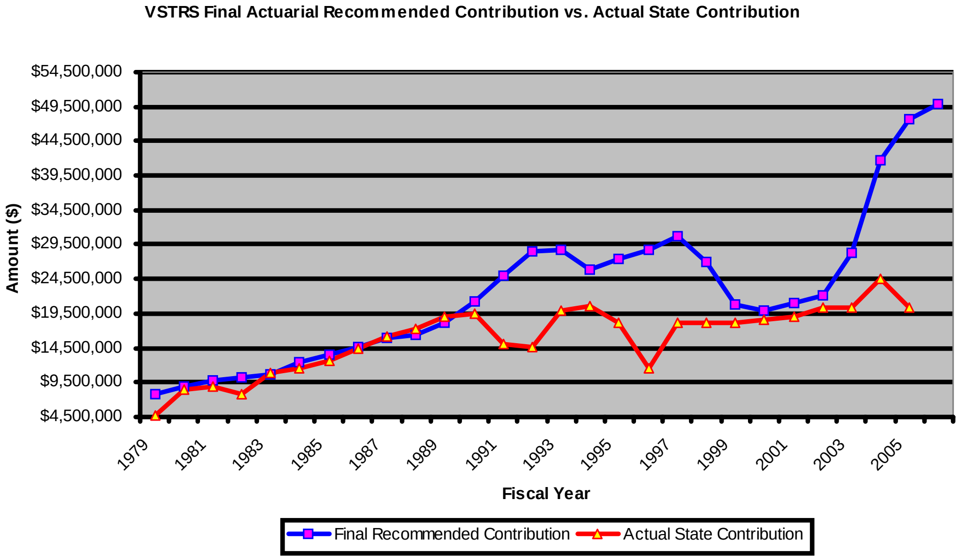


10

Note: Funding percentage based on GASB No. 25.

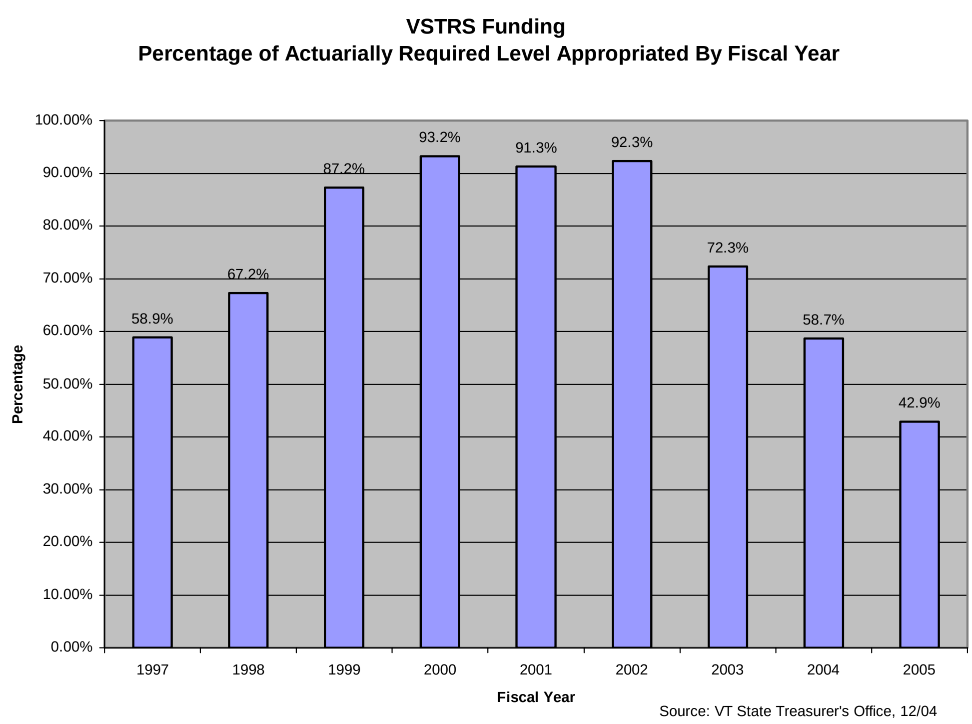


11



Note: Final recommended contribution is developed in October of the same fiscal year. FY 05 and 06 are projected based on actuarial valuation.

12



VSTRS Liability Looking Forward

Fiscal Year	Projected Payroll	Normal Rate	CONTRIBUTIONS Normal	Accrued Liability	Total
2005	$ 453,517,153	7.79 %	$35,328,986	$12,385,332	$47,714,318
2006	473,925,000	7.79%	36,919,000	13,004,599	49,923,599
2007	495,252,000	7.79%	38,580,000	13,564,829	52,234,829

14

How VSTRS Compares to Other Public Funds: 2004 Wilshire Report

•Assets of large state pension funds fell 4% in 2003, while liabilities grew 6%, according to a 2004 survey by Wilshire Associates Inc.

•State pension plans have a combined shortfall of $366 billion dollars in 2003 as compared to $180 billion in 2002.

• Of the 123 state funds in the survey, 93% are underfunded, according to Wilshire, up from 79% in 2002, 51% in 2001, and 31% in 2000.

•Wilshire forecasts a long-term return on state pension assets of about 7.2% per annum, slightly below the VSTRS average **actuarial** interest rate assumption of 8%.

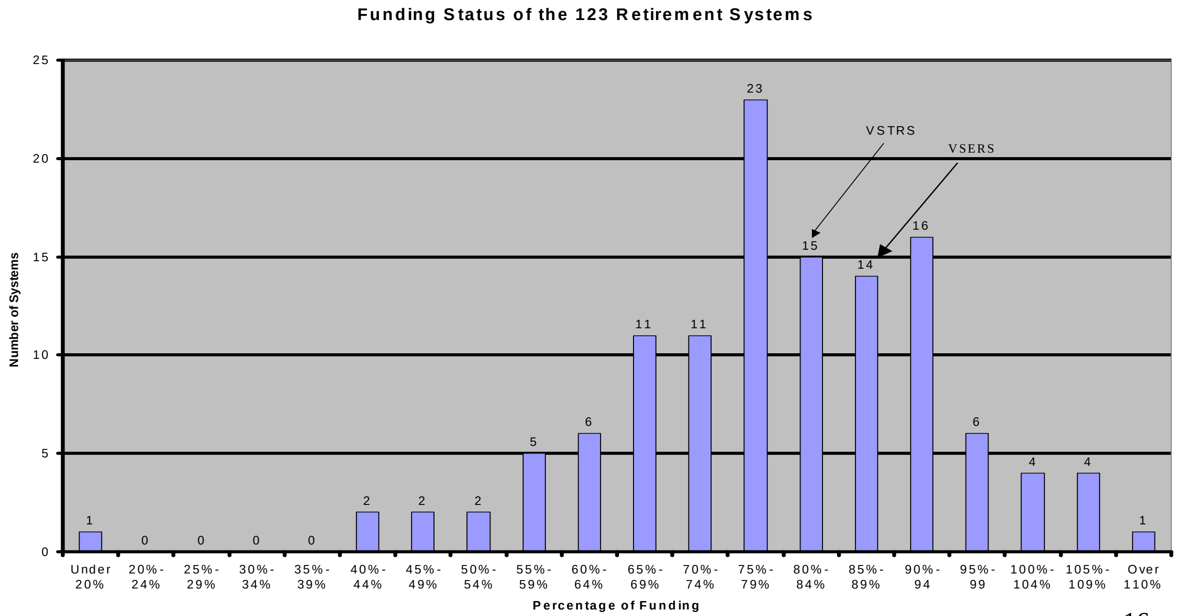
•Vermont's actuarial assumption was reduced from 8.5% to 8%, but still is higher than the Wilshire estimate.

15

Source: Wilshire Associates, 2003, 2004

Keep in mind that the reporting of data on public retirement systems lacks uniform timeliness and disclosure.

Vermont Retirement Systems: Where do We Stand in Comparison to Other States?



Source: Wilshire Report, 2004. Note: these are stated at market value, not actuarial value.

State Comparative Data

Assets minus liabilities (millions) and rank out of 123 systems:

Best		**Worst**	
1 North Carolina PERS	$7,024	123 New York PERS	-$25,055
2 Florida RS	$3,059	122 Illinois Teachers	-$23,809
3 California Regents	$2,372	121 California PERS	-$21,174
4 New York STRS	$1,348	120 Ohio STRS	-$21,134
5 Georgia PERS	$ 997	119 Texas Teachers	-$16,630

21 Vermont VSERS -$155 (last year ranked 41, -$128 million)
29 Vermont VSTRS -$260 (last year ranked 51, -$241 million)

Source: Wilshire Associates, 2003,2004

State Comparative Data

Ratio of assets (market value) to liabilities and rank out of 123 systems:

Best		Worst	
1 North Carolina PERS	118%	123 W. Virginia STRS	19%
2 New Jersey State Police	108	122 Indiana STRS	42
3 Georgia PERS	108	121 Illinois PERS	42
4 California Regents	107	120 Oklahoma STRS	49
5 North Carolina Local	106	120 Illinois STRS	49

32 Vermont VSERS 88%*
58 Vermont VSTRS 81%*

* Uses market value, not actuarial.

Source: Wilshire Associates, 2003, 2004

18

State Comparative Data

Combined State pension unfunded liabilities as a % of State Budget Expenditures

Best		Worst	
1 North Carolina	-55%	50 Nevada	269%
2 Florida	-15%	49 Mississippi	210%
3 South Dakota	4%	48 Oklahoma	206%
4 Georgia	6%	47 Illinois	197%
5 Tennessee	8%	46 Colorado	196%
6 New Jersey	9%	45 West Virginia	186%
7 California	33%	44 Michigan	179%
8 Nebraska	46%	43 Wyoming	175%
9 Delaware	47%	42 Louisiana	167%
10 Vermont	47%	41 Rhode Island	133%

Note: Only two states have combined positions with no unfunded liability

Significant drop-off from levels of top six rated states

10 Vermont 47% (last year 42%)
(Combined Systems Total)

Source: Wilshire Associates, 2003, 2004

19

Impacts of Underfunding

- Continued underfunding will further increase the tax burden for future generations of taxpayers.
- Taxpayers in Vermont are already bearing the burden of past underfunding. For example, if additional funding had not been required to make up for prior shortfalls, the recommended contribution for FY 2004 would have been $14 million less than it was.
- Lost investment earnings will also need to be repaid. The approximate cumulative effect of lost earnings since 1979 is $120 million.
- Based on an underfunding study completed last year, if there had been no shortfall in contributions, the funded ratio would have been 99.2% instead of 89.6% as of June 30, 2003.
- Could increase pressure, in the absence of a budgetary solution, to reduce employee benefits and/or lead to a disproportionate increase in employee contributions.

20

Potential Impacts of Underfunding on Vermont's Credit Rating

"Pension funding is an important element of credit analysis because pension expense has a direct effect on current budgets and a long-term impact on overall financial flexibility. Contractually obligated pension expenditures, along with debt service commitments, are amongst a governmental entity's fixed-cost burden, pulling resources from other essential programs.... Fitch Ratings expects few, if any, downgrades to occur solely as a result of rising pension costs. However, increasing pension expenses can contribute to or exacerbate declines in liquidity and financial flexibility that may lead to downgrades in the absence of corrective action."

-Fitch Rating Service: September 18, 2003

21

Example of "lost interest" from just one year of underfunding

If the 1982 contribution had been increased by $2.3 million to its actuarially recommended level, the fund would have earned an additional $36.6 million in interest through June 30, 2004.

"Lost interest" on 1982 Contribution

Year	Principal	Investment Return	Interest "Lost"	Accumulated Interest
1982	$2,377,449	20.60%	489,754	489,754
1983	$2,867,203	20.70%	593,511	1,083,265
1984	$3,460,714	9.90%	342,611	1,425,876
1985	$3,803,325	24.00%	912,798	2,338,674
1986	$4,716,123	21.10%	995,102	3,333,776
1987	$5,711,225	18.70%	1,067,999	4,401,775
1988	$6,779,224	16.30%	1,105,014	5,506,789
1989	$7,884,238	18.90%	1,490,121	6,996,910
1990	$9,374,359	-1.00%	(93,744)	6,903,166
1991	$9,280,615	18.60%	1,726,194	8,629,360
1992	$11,006,809	10.80%	1,188,735	9,818,095
1993	$12,195,544	12.10%	1,475,661	11,293,756
1994	$13,671,205	4.90%	669,889	11,963,645
1995	$14,341,094	16.20%	2,323,257	14,286,902
1996	$16,664,351	18.50%	3,082,905	17,369,807
1997	$19,747,256	22.30%	4,403,638	21,773,445
1998	$24,150,894	16.90%	4,081,501	25,854,946
1999	$28,232,395	11.20%	3,162,028	29,016,974
2000	$31,394,423	8.60%	2,699,920	31,716,894
2001	$34,094,343	-1.60%	(545,509)	31,171,385
2002	$33,548,834	-4.70%	(1,576,795)	29,594,590
2003	$31,972,039	5.60%	1,790,434	31,385,024
2004	$33,762,473	15.70%	5,300,708	36,685,732

22

Funding Options:

- Rely on investment returns to buoy system
  - *Without increases in contributions, investment returns will simply not be sufficient to cover liabilities.*
- Revise funding schedule to increase amortization timeline
  - *Analogous to extending your mortgage.*
  - *Short-term budget solution, but increases costs significantly in long run.*
  - *May raise eyebrows at rating agencies.*

23

Funding Options:

- Pension Obligation Bonds -- Borrow to raise funds to close funding gap at interest rates lower than anticipated investment returns
  - *Competes with other bonding needs; adds to State debt.*
  - *While returns may be higher than debt payments, the reverse can happen as well. Some retirement funds employing this strategy did not make enough to pay debt service over last few years.*
  - *Would definitely raise eyebrows at rating agencies.*
- Increase Employee Contribution
  - *By itself, not a fair solution, as teacher contributions have not faltered over the years.*
  - *Shifts burden and alters the promised IOU.*

24

Funding Options:

- **Increase Employer Contribution**

  - Requires legislative commitment to increase funding over time to match actuarially required contributions.

- **Use a significant portion of surplus or "waterfall" funds to address unfunded liability**
  - *Temporary solution, but does not address the underlying problems*

25

Funding Options:

- **Combination of above**:
  - *No one solution likely to be large enough to make up the gap*
  - *Various combinations of increased employer contributions at the state and local levels, "waterfall"appropriations, and/or employee contribution increases might be necessary to obtain a solution within the context of budget constraints and fairness to employees.*
  - *Share the burden over long term.*